

ORIGINAL OPEN MEETING AGENDA ITEM



0000090755

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON, Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

EXCEPTION

2008 NOV 21 P 2:09 Arizona Corporation Commission

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IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE
COMPANY FOR A HEARING TO
DETERMINE THE FAIR VALUE OF THE
UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX
A JUST AND REASONABLE RATE OF
RETURN THEREON, AND TO APPROVE
RATE SCHEDULES DESIGNED TO
DEVELOP SUCH RETURN

DOCKET NO. E-01345A-08-0172

EXCEPTIONS OF ARIZONA
PUBLIC SERVICE COMPANY
TO RECOMMENDED ORDER

(INTERIM RATE REQUEST)

INTRODUCTION

The evidentiary hearing conducted in this matter resulted in a consensus by all witnesses that (1) Arizona Public Service Company's ("APS" or the "Company") current financial condition places at risk the Company's ability to promote a sustainable energy future for Arizona and threatens APS and its customers with significant increased financing costs that, at the time of the hearing, were estimated to be \$1 billion; and (2) this risk has been heightened in the face of the most severe financial crisis in this country's history.

Our nation – indeed, the entire world – faces an unprecedented financial emergency, the significance of which cannot be overstated or overlooked. Triggered in late summer 2007 by difficulties in the U.S. sub-prime mortgage market, the country's financial crisis came to a head on September 14, 2008 – the eve of the Company's

1 interim hearing and “one of the most dramatic days in Wall Street’s history”¹ – when
2 Merrill Lynch, a major investment firm and a pillar of Wall Street, sold itself to Bank of
3 America to avert its deepening financial crisis. That same day, another prominent
4 securities firm, Lehman Brothers, declared bankruptcy – the largest bankruptcy in U.S.
5 history. These moves, which themselves “reshaped the landscape of American
6 finance,”² were the first of many momentous if ominous events in a credit market that
7 has deteriorated rapidly since. Indeed, since the conclusion of the hearing in this
8 matter:

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10 • On September 21, 2008, in attempt to counteract a looming threat of
11 bankruptcy, Goldman Sachs and Morgan Stanley, huge “gold standard”
12 investment banks, asked the Federal Reserve to convert their status from
13 independent investment banks to commercial banks – a radical shift in the
14 nature of their business that represented an assault on those firms’ culture
15 and transformed the face of Wall Street;
- 16 • On September 25, 2008, Washington Mutual, the largest savings bank in
17 the country, collapsed, resulting in an emergency sale to JPMorgan
18 Chase;
- 19 • On September 29, 2008, the Dow Jones industrial average fell 777.68
20 points, the largest one-day point loss in history, as the United States
21 House of Representatives rejected the latest bailout measure;
- 22 • On October 3, 2008, a floundering Wachovia Bank was purchased by
23 Wells Fargo, after earlier indications that it would be bought-out by
24 Citigroup;
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27 ¹ See New York Times, “Lehman Files for Bankruptcy; Merrill is Sold,” September 14, 2008.

28 ² See id.

- 1 • On October 10, 2008, notwithstanding the signing of a federal bailout
2 plan just one week prior, the Dow Jones ended seven consecutive days of
3 losses and completed its worst week in the country's history;
- 4 • As of November 20, 2008, Citigroup – the largest money center bank in
5 the world – teeters on insolvency, and recently announced plans to cut
6 53,000 jobs.

7 The cascading effect of these events is impossible to predict or even fully
8 comprehend. In the short run, the nation's financial emergency has triggered an
9 increase in the cost of borrowing and a decrease in the availability of credit, both of
10 which have a significant impact on non-financial institutions like APS, not to mention
11 the overall economy. Because of tightening credit conditions, it has become more
12 expensive and difficult, if not impossible, for even investment-grade businesses –
13 including APS – to borrow funds.

14 In light of the striking deterioration in the financial markets, APS now estimates
15 that the increased financial costs involved with a downgrade to “junk” credit status
16 could reach as much as \$3 billion³, if it is even able to access the market at all with such
17 a rating. Even with the Company's current “one step from junk” BBB- bond rating,
18 APS has been unable to access the long-term debt market since the hearing in this
19 matter, causing it to rely heavily on existing lines of credit. But even the Company's
20 **existing** credit lines have been impacted by the nation's financial crisis. The collapse
21 of Lehman Brothers caused a loss of \$51 million of available credit capacity. If
22 Citigroup goes under, the remainder of the Company's existing lines of credit could be
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27 ³ This calculation is an estimate based on the best data available to the Company as of the time of this
28 filing.

1 significantly compromised and APS will face a liquidity crisis that no subsequent
2 regulatory or legal action will be able to resolve.

3 Yet in spite of this indisputable and worsening crisis, the Recommended Opinion
4 and Order ("Recommended Order") asserts that the Arizona Corporation Commission
5 (the "Commission") – the most powerful agency in the State, with plenary authority
6 over rates – is powerless to act. Such a result cannot have been intended by or even
7 within the contemplation of those Arizonans who created this Commission nearly 100
8 years ago.

9 Pursuant to A.A.C. R14-3-110(B), APS hereby submits to the Commission its
10 Exceptions to the Recommended Order and urges the Commission to exercise its well-
11 established constitutional authority, adopt the Company's proposed amendment
12 (attached hereto at Tab 1) and grant APS the interim relief requested.

14 SUMMARY

15 The Company's Motion for an Interim Rate Surcharge ("Motion") is about more
16 than APS's credit metrics and earnings. It is about more than regulatory lag. It is about
17 more than the meaning of the single word, "emergency." Instead, the Motion is about
18 the long-term energy future of Arizona – a future that requires significant investment in
19 electric infrastructure and resources to ensure our State's energy sustainability and
20 independence. The investments that Arizona needs today to prepare for the future
21 range from the most basic of electric distribution facilities, to projects like Solana and
22 other large-scale renewable generating plants, to new innovative technologies, such as
23 Advanced Metering Infrastructure (or "smart meters") that will provide Arizona with a
24 more reliable, responsive distribution system. Historically, both the Commission and
25 APS have together taken important steps to implement policies intended to foster such a
26 future.
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1 These investments are substantial, and there is no doubt that APS must be
2 financially healthy to be able to make them. In fact, witnesses for every party to this
3 docket agreed that it is important to our State's energy future that APS not just maintain
4 its current "one small step away from junk" credit grade, but that it improve to **higher**,
5 **safer** credit ratings so that the Company is sufficiently positioned to raise the billions of
6 dollars needed to make the investments that are so critical to this State – a need that is
7 significantly enhanced by the current precarious state of our nation's financial markets.

8 This is undoubtedly a time of financial crisis for APS. In fact, every party to this
9 proceeding agreed that, without the interim relief requested, APS faces the risk of a
10 downgrade to "junk" credit levels, and that such an event could make it virtually
11 impossible for the Company to fund the investments necessary to secure Arizona's
12 energy future. Against this tide of common understanding, and without sufficient
13 regard to the evidence presented during the hearing in this matter, the Recommended
14 Order recommends that the Commission deny the Company the relief requested and
15 instead take the potentially very expensive gamble that APS's credit rating will remain
16 investment grade through the conclusion of its permanent rate filing – which could be
17 more than a year away. The Recommended Order places this enormous bet
18 notwithstanding the fact that the interim relief requested, which would likely stave off
19 the threat of a downgrade, would be subject to refund with interest at the close of the
20 Company's permanent rate case and is thus relatively inexpensive insurance against the
21 significant harm that will befall APS and its customers if the Commission adopts the
22 Recommended Order and the Company is downgraded as a result. Such a willingness
23 to gamble Arizona's energy future in the midst of the economic turmoil now facing
24 Arizona and this country will itself further damage the Company's standing in the
25 financial community. In fact, one prominent financial analyst reacting to the
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1 Recommended Order concluded in a published report that it is “**hard to see why**
2 **anyone would want to own APS debt or the equity of PNW with this type of**
3 **regulatory treatment and recovery in Arizona.**”⁴

4 From a legal perspective, APS strongly disputes several of the Recommended
5 Order’s findings and ultimate conclusions, many of which contradict both the evidence
6 presented at the hearing and the positions of most of the parties and intervenors in this
7 matter. Specifically, APS disagrees with the Recommended Order’s conclusions that
8 (i) the Commission lacks authority to grant interim rate relief absent a finding of an
9 emergency; (ii) the financial circumstances now threatening APS do not constitute an
10 emergency or otherwise justify interim relief; and (iii) APS’s poor financial condition
11 (caused by regulated prices set below current costs) was somehow caused by its own
12 operational and financial decisions and can be remedied absent rate relief from the
13 Commission.
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15 The evidence at the hearing clearly demonstrated that APS faces a severe risk of
16 a credit-rating downgrade – a risk that is becoming even more likely given current and
17 forecasted market conditions. Virtually every party to this matter agrees that the
18 Commission has the clear authority under the Arizona Constitution and established
19 precedent to grant APS relief, and all but two agree that the significant risk justifies
20 interim relief. In addition, all parties – and even the Recommended Order –
21 acknowledge that a credit-rating downgrade will cause long-term harm not only to APS
22 but also to the Company’s customers, who ultimately will be forced to pay for this
23 avoidable added financial burden.
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27 ⁴ See John Kiani, Deutsche Bank, November 13, 2008 “Pinnacle West Capital, Regulatory Environment
28 Still Negative in Arizona,” attached hereto at Tab 2.

1 Given the overwhelming evidence established at the hearing regarding the
2 causes and consequences of APS's current financial condition – including near-
3 consensus of the other parties – as well as the Commission's ability to alleviate the risk
4 of a downgrade while minimizing the impact on customers, APS urges the Commission
5 to take action and adopt the Company's proposed Amendment (attached hereto) and
6 grant APS the critical interim relief that it seeks.

7 **I. THE RECOMMENDED ORDER'S CONCLUSION THAT THE**
8 **COMMISSION LACKS AUTHORITY TO GRANT INTERIM RELIEF**
9 **ABSENT A FINDING OF AN EMERGENCY IS ERRONEOUS AS A**
10 **MATTER OF LAW.**

11 Far from a novel interpretation or expansion of the Commission's constitutional
12 authority, the legal position taken by APS – as well as that argued by Staff, Arizona
13 Investment Council ("AIC"), Freeport-McMoRan Copper & Gold Inc. and Arizonans
14 for Electric Choice and Competition ("AECC"), and the Mesquite Group ("Mesquite")
15 – that the Commission has the power to award interim relief under the circumstances
16 now facing APS is well-founded and long standing in Arizona law and the
17 Commission's past decisions. Contrary to well-established precedent, the
18 Recommended Order incorrectly concludes that the Arizona Constitution renders the
19 Commission powerless to award interim relief to APS in this proceeding absent a
20 finding of a "current emergency." Acceptance by the Commission of this extreme
21 limitation on its own authority is not only inconsistent with past Commission action,
22 but would seem to significantly restrict the Commission's rate-making authority going
23 forward.

24 As each of the parties to this proceeding agrees, Arizona law is clear that the
25 Commission has broad power to grant appropriate rate relief based on the particular
26 facts and circumstances facing a utility. According to Arizona Attorney General
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1 Opinion 71-17 (“Opinion 71-17”), an oft-cited authority on the issue of interim rates on
2 which the Recommended Order heavily relies, “the Commission’s powers are not
3 limited to those expressly granted by the Constitution;” rather, “the Commission may
4 exercise all powers necessary or essential in the performance of its duties.” Op. Att’y
5 Gen. 71-17 at 2-3 (citing *Garvey v. Trew*, 64 Ariz. 342, 346, 170 P.2d 845, 848 (1946));
6 *see also Ariz. Corp. Comm’n v. Super. Ct.*, 107 Ariz. 24, 26, 480 P.2d 988, 990 (1971)
7 (“[N]o other state has given its commission the extensive power and jurisdiction that
8 the Arizona Corporation Commission possesses.”). Indeed, Opinion 71-17 underscores
9 “the Commission’s broad and exclusive legislative power to choose the modes by
10 which it establishes rates” as well as its ability “to avail itself of concepts and
11 procedures which are devised from time to time to permit effective utility regulation
12 and to keep pace with constantly changing economic and social conditions.” Op. Att’y
13 Gen. 71-17 at 3 (internal quotation marks and citation omitted).

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15 Similarly construing the scope of the Commission’s authority, courts – and the
16 Commission itself – often have granted interim relief without an express finding that an
17 emergency existed and without conducting a full fair-value analysis. *See, e.g., Pueblo*
18 *Del Sol Water Co. v. Ariz. Corp. Comm’n*, 160 Ariz. 285, 287, 772 P.2d 1138, 1140
19 (App. 1988) (holding that inability to conduct general rate review in reasonable time
20 justified relief and that “[i]nterim rates are not limited to emergency situations”); *Ariz.*
21 *Corp. Comm’n v. Mountain States Tel. & Tel. Co.*, 71 Ariz. 404, 228 P.2d 749 (1951)
22 (utility entitled to interim relief where Commission’s normal ratemaking process would
23 not be completed in reasonable time); Decision No. 69568 (May 21, 2007) (interim
24 relief justified by ability to minimize negative effect on utility’s finances while
25 avoiding “yo-yo” rate impact).

1 Significantly, with a single exception, **every one of the parties** to this
2 proceeding agrees that the Commission may grant interim rate relief **without** finding
3 the existence of a current emergency. Staff, for example, agrees that the mere risk of a
4 **future** emergency is a sufficient basis for the Commission to exercise its broad
5 authority and establish interim rates. *See, e.g.*, Staff's Initial Post-Hearing Brief at 7-11
6 ("The plenary and exclusive Constitutional authority of the Commission over rates
7 would seem to necessarily encompass the ability to act to prevent an emergency from
8 occurring just as much as it encompasses the ability to act to alleviate an emergency
9 that is in the process of occurring or has occurred."). Similarly, AIC, AECC, and
10 Mesquite all believe that the Commission has broad authority to grant interim relief to
11 protect both the Company and its customers **irrespective of the existence of an actual**
12 **emergency**. *See, e.g.*, AIC's Opening Brief at 7-10; AIC's Response Brief at 6;
13 AECC's Reply Brief at 3-4; Mesquite's Closing Brief at 2-4. Even the Recommended
14 Order notes that "under certain circumstances, an "emergency" could be found to exist
15 when the absence of action would cause the emergency event(s) to occur." *See*
16 Recommended Order at 30.

18 Despite the concurrence of nearly all other parties regarding the scope of the
19 Commission's authority, and inconsistent with other conclusions reached in its analysis,
20 as noted above, the Recommended Order ultimately concludes that the Commission's
21 authority to award interim relief is limited exclusively to three circumstances: (i)
22 emergencies narrowly characterized by sudden changes that cause hardship to a utility,
23 insolvency, or an inability to maintain service pending a formal rate determination; (ii)
24 the inability to grant permanent rate relief in a reasonable time following a court or
25 Commission decision that rates are confiscatory; or (iii) rate increases approved through
26 a previously established adjustor mechanism. *See* Recommended Order at 25-26.

1 In so narrowly limiting the Commission's constitutionally-established rate-
2 making powers to these three instances, the Recommended Order selectively applies
3 certain legal authorities and unsuccessfully attempts to distinguish others that
4 undermine its conclusions. For example, despite relying on Opinion 71-17, the
5 Recommended Order overlooks the fact that Opinion 71-17 actually **emphasizes** the
6 Commission's constitutional authority to tailor relief to the particular circumstances
7 facing a utility, and does **not** condition the awarding of interim relief on a finding of an
8 actual emergency or otherwise limit the factors that may justify relief, a point
9 recognized by virtually every party to this proceeding. See, e.g., Staff's Post-Hearing
10 Reply Brief at 2 ("Staff disagrees with [the] conclusion that the Commission's ability to
11 award interim rates is limited to emergency circumstances."); Ahearn Testimony at
12 1070:22 to 1071:4 (testifying, in contrast to the position taken in RUCO's post-hearing
13 brief, that Opinion 71-17 did not intend to present an "all-inclusive list of
14 circumstances" that might qualify as an "emergency" justifying interim relief).

16 Nor, contrary to the Recommended Order's suggestion otherwise, is there any
17 requirement that interim relief may be justified upon a finding of unreasonable delay in
18 setting adequate rates only in the limited instance where a court or the Commission has
19 also made a prior finding that a utility's rates are confiscatory. Such a position is found
20 nowhere within the *Mountain States* opinion, which was relied upon by the
21 Recommended Order for this proposition. Although the *Mountain States* court
22 empowered a corporation to set its own rates after those set by the Commission were
23 invalidated by the *Mountain States* court as confiscatory, rendering an opinion and
24 specifying a course of action on those facts is a far cry from declaring a court-imposed
25 requirement that restricts the **Commission's** plenary authority to award interim relief to
26 those situations where the Commission also makes a preliminary legal finding that a
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1 company's current rates are confiscatory. Indeed, in giving examples of situations that
2 would justify interim relief, Opinion 71-17 expressly lists "the inability of the
3 Commission to grant permanent relief within a reasonable time" as one such
4 circumstance, with no mention of an attendant need to find that the company's prior
5 rates are confiscatory. Opinion 71-17 at 8.

6 In addition, the conclusions reached in the Recommended Order are contradicted
7 by past Commission decisions and even by the Recommended Order's own
8 acknowledgement of the scope of the Commission's authority. For example, the
9 Commission previously has expressly found that "our authority to determine
10 emergencies is not limited to specific, narrowly tailored facts, and that our ratemaking
11 authority is sufficiently broad to enable us to grant relief tailored to many different
12 situations." Decision No. 68685 (May 5, 2006) at 23. The Recommended Order itself
13 cites to that prior decision in stating that not only does the Commission's ratemaking
14 authority encompass the ability to grant emergency relief, but "in other situations, the
15 circumstances or public interest may require other forms of relief." Recommended
16 Order at 35. And while the Recommended Order acknowledges that "under certain
17 circumstances, an 'emergency' could be found to exist when the absence of action
18 would cause the emergency event(s) to occur," it then applies a different standard in
19 rejecting APS's request after concluding that no current emergency exists. *Id.* at 30-31.

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21 Finally, Opinion 71-17 expressly **rejects** the argument that the Arizona
22 Constitution requires a fair-value analysis in order to award interim relief – even in
23 "non-emergency" situations. Op. Att'y Gen. 71-17 at 10. This is so because interim
24 rates will eventually become a part of a permanent rate increase or be refunded to
25 ratepayers with interest following a fair value determination made after full
26 examination of all relevant data in the permanent rate case. And in any event, as
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1 explained in both APS's Initial Post-Hearing Brief ("APS Brief") as well as Staff's
2 Initial Brief, the nature of the Company's request is such that a finding of fair value can
3 be made on the evidence in the record. *See* APS Brief at 12-13. The Recommended
4 Order rejects this option out-of-hand without adequate explanation or justification.

5 But even if the Commission concluded that the Recommended Order correctly
6 expresses the limits of the Commission's constitutional authority, APS has
7 demonstrated, as discussed below, extraordinary circumstances that the undisputed
8 facts, compelling public policy interests, and the Commission's responsibility to the
9 future of our State compel the granting of interim relief in this case.

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11 **II. THE RECOMMENDED ORDER DISREGARDS THE SUBSTANTIAL**
12 **EVIDENCE IN THE RECORD THAT THE CIRCUMSTANCES FACING**
13 **APS CONSTITUTE AN "EMERGENCY" AND JUSTIFY INTERIM**
14 **RELIEF.**

15 Prior to the hearing in this matter, APS faced critical financial problems that
16 justified the interim relief sought in its June 6, 2008 Motion under any applicable legal
17 standard. APS faced then (and still faces today) a severe financial crisis, one that the
18 Company has frequently deemed an "emergency" throughout these proceedings, despite
19 the Recommended Order's contention otherwise. *See* Brandt Affidavit at 5-7 9-10;
20 Brandt Rebuttal Testimony at 8-11, Cicchetti Affidavit at 4, 10-13.⁵ APS's financial
21 crisis is caused by the Company's extraordinary capital requirements (spending levels
22 of hundreds of millions of dollars annually that are exacerbated by severe inflation in
23 key materials and commodity costs, foreign exchange pressures, and volatility in the
24 capital markets) coupled with a prolonged lag in the recovery of prudently incurred
25 costs. *See, e.g.,* Brandt Rebuttal Testimony at 6-8.

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27 ⁵ APS will cite to hearing testimony using this format. In the example cited, the testimony begins on
28 page 710 of the transcript at line 16 and extends to page 711 at line 5.

1 And despite the Recommended Order's suggestion to the contrary, *see*
2 Recommended Order at 31, the evidence at the hearing showed that, notwithstanding
3 recent cost-cutting efforts by APS amounting to more than \$700 million over the next
4 three years, these capital expenditures cannot be "managed" in a way that will resolve
5 the Company's financial problems without also jeopardizing APS's ability to meet its
6 basic service obligations, let alone make the investments needed to promote and support
7 a sustainable energy future for the State. *See* Brandt Rebuttal Testimony at 4 and 17;
8 Post Rebuttal Testimony at 10-11; Post Hearing Testimony at 710:16-711:5. There is
9 simply no evidence that APS can "cost-cut" its way out of this financial crisis. Without
10 rate relief, APS is forced to charge its customers prices that are far below the
11 Company's true cost of service.
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13 Contrary to the Recommended Order's characterization of the Company's
14 position, APS does not contend that the insufficient rates resulting from the rate-making
15 process are themselves the emergency. Rather, they are the **source** of the crisis: the
16 striking deterioration in the Company's financial condition over the past several years
17 to the point that APS's earnings are several hundred basis points below its allowed rate
18 of return and its credit metrics hover just above junk-bond status and are projected to
19 fall **significantly** below that level before the resolution of the permanent rate case. *See*
20 Brandt Hearing Testimony at 520:25-521:11; Brandt Rebuttal Testimony at 22-23. As
21 a result – and as **every party** to this interim proceeding acknowledged – APS faces a
22 threat that it will be downgraded to non-investment ("junk") credit grade before the
23 Commission is able to rule on its pending permanent rate request, with grave
24 consequences not only to the Company, but to both APS customers and the very
25 economic and energy future of our State. These are far from the consequences of
26 "normal" utility regulation as the Recommended Order suggests, (*see* Recommended
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1 Order at 31) – but rather demonstrate the very type of extraordinary conditions that
2 interim rate relief was designed to address.

3 All of the foregoing was true in the days leading up to the hearing, justifying the
4 Company's urgent need for interim rate relief. But, as previously discussed, the world
5 changed in the days leading up to and following the hearing. The nation's financial
6 markets took a devastating turn: major investment banks and financial institutions were
7 taken over or collapsed, equity markets essentially evaporated, the long-term debt
8 market closed to even investment grade borrowers (including APS), and credit rating
9 agency accountability for taking decisive ratings action rose to new heights. Indeed, the
10 day before the hearing, Alan Greenspan, a former and long-time Federal Reserve
11 chairman, declared that the country was experiencing a "once in a lifetime financial
12 crisis." *See* APS Opening Remarks, Hearing Transcript 19: 20-25.

14 Whatever the parties' expressed positions prior to the events that took place in
15 the world's financial markets in the days leading up to the hearing, the impact of those
16 events on the Company's need for interim rate relief was dramatic – an impact that was
17 universally recognized by all parties to the proceeding. *See* Staff Brief at 2, 9 and 36;
18 RUCO Reply Brief at 1; AIC Brief at 2; AECC Reply Brief at 4. Indeed, in some cases,
19 the uncertainty created by the devastation in the nation's economy caused parties to
20 reformulate their pre-filed Direct Testimony. For example, despite statements made in
21 the parties' pre-filed testimony, after hearing the evidence presented at the hearing, **not**
22 **a single party was willing or able to testify that a downgrade to APS's bond ratings**
23 **would not occur absent interim relief.** *See, e.g.,* Ahearn Testimony at 1064:25-
24 1065:2; Smith Testimony at 630:2-14; Higgins Testimony at 279:3-18; Parcell
25 Testimony at 895:11-24, 897:12-898:10, 908:18-24. In fact, specifically in light of the
26 evidence presented at the hearing, Staff Witness David Parcell concluded that he was
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1 unable to state that APS is not presently at “substantial” risk of a credit ratings
2 downgrade, but rather indicated that there are “several uncertainties” on “several
3 important questions” (such as the impact of the current financial crisis on APS’s rating
4 prospects) that make the risk of downgrade a distinct possibility. *See* Parcell Testimony
5 at 895:11-24, 897:12-898:10, 908:18-24. Similarly, RUCO Director Steven Ahearn
6 testified that, as an advocate for consumers, a belief that just a **25 percent chance** that a
7 downgrade would occur absent interim rate relief would cause him to “seek an option to
8 reduce the likelihood of the event occurring” (such as the interim relief requested), and
9 that his opinion as to whether or not the Company’s **current** risk of downgrade could
10 be characterized as an emergency “might well be different” if he were a Commissioner
11 (whose Constitutional responsibilities require a careful balancing of all relevant
12 interests) instead of an advocate for particular customers. *See* Ahearn Testimony at
13 1073:11-25; 1084:1-8.

15 As the foregoing makes clear, the uncertainty of how APS’s already precarious
16 financial health would be impacted by the nation’s economic meltdown and how to
17 address it was a key theme of the hearing and post-hearing briefs, and three important
18 concepts emerged over which there was no dispute:

- 19 1. to serve Arizona reliably and implement the Company’s vision of creating
20 a sustainable and independent energy future for our State, APS must be
21 financially healthy and should be **as far from a junk credit rating as**
22 **possible**, *see* Smith Testimony at 688:24-689:6; Parcell Testimony at
23 979:17-980:7; Ahearn Testimony at 1063:22-1064:4; Higgins Testimony
24 at 236:1-24, 237:4-16; Cicchetti Testimony at 806:24-807:6, 810:25-
25 811:16, 883:20-884:2;

- 1 2. **APS is currently at risk of a credit ratings downgrade to junk levels,**
2 an event that – if it occurs – would not only substantially increase
3 financing costs to customers (in an amount estimated at the time of the
4 hearing to be \$1 billion, but which today would be approximately \$3
5 billion because of the continued deterioration of the financial markets) but
6 would very likely prevent APS from even **entering** the capital markets to
7 issue junk-rated debt, and would, in any case, undeniably stand in the way
8 of APS meeting the needs for Arizona’s energy future; *see, e.g.,* Higgins
9 Testimony at 248:18-250:9; Brandt Testimony at 439:1-16; Smith
10 Testimony at 683:115-684:20; and
11
12 3. the Company’s risk of downgrade, whatever its level prior to the hearing,
13 has clearly been exacerbated in the face of the country’s recent financial
14 crisis, *see* Staff Brief at 2, 9 and 36; RUCO Reply Brief at 1; AIC Brief at
15 2; AECC Reply Brief at 4.; Parcell Testimony at 895:11-24.

16 However, the Recommended Order’s analysis and recommendation does not
17 discuss or even acknowledge the evidence presented at the hearing and focuses almost
18 exclusively on the parties’ pre-filed Direct Testimony. Although the Recommended
19 Order notes that it is “cognizant of the recent turmoil in the financial markets, of the
20 state of the economy in general, and of the risk that a downgrade to non-investment
21 grade credit rating could have on APS and its ratepayers,” *see* Recommended Order at
22 35, it avoids **any** discussion of how these critical factors impact the Company’s
23 potential for downgrade or why the undisputed belief that a threat of downgrade to junk
24 credit grade (and its attendant and devastating consequences) exists is insufficient to
25 justify the relief requested. Indeed, absent from the Recommended Order’s analysis is
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1 any consideration of the several key and undisputed facts discussed at length during the
2 hearing that make the Company's need for interim relief compelling:

- 3 • That, due to weak and deteriorating financial metrics, APS's credit ratings
4 have fallen to a level just above junk status, clinging to the lowest level
5 for investment grade under Standard & Poor's rankings (BBB-) and the
6 second-lowest level for investment grade according to Moody's and
7 Fitch's rankings (Baa2 and BBB, respectively). Only a handful of other
8 investor-owned utilities nationwide have bond ratings that are worse than
9 those of APS. See Brandt Affidavit (APS Exhibit 1) at 11; Parcell
10 Testimony at 955:11-24.
- 11 • That both S&P and Moody's have expressly told three APS executives
12 [including Mr. Donald Brandt, Mr. James Hatfield (the Company's Senior
13 Vice President and Chief Financial Officer), and Ms. Barbara Gomez
14 (APS's Vice President and Treasurer)] that APS must maintain an
15 FFO/Debt ratio of at least 18 percent to maintain its current BBB- credit
16 rating because of what these agencies perceive to be Arizona's
17 challenging regulatory environment. See Brandt Rebuttal Testimony
18 (APS Exhibit 2) at 26-27; Brandt Testimony at 91:5-13, 386:16-23.
- 19 • That S&P, which currently rates APS's debt just one step above "junk"
20 credit status, has expressly informed APS not only that it must maintain
21 an FFO/Debt ratio in the upper end of the range applicable to utilities (at
22 least 18 percent), but that it intends to reevaluate APS's credit rating in a
23 credit rating committee meeting **after the Commission rules on the**
24 **Company's interim request.** See, e.g., Brandt Rebuttal Testimony (APS
25 Exhibit 2) at 26-27; Brandt Testimony at 143:5-10; 203:14-22.

- That, notwithstanding the significant cost-cutting measures that the Company has undertaken, the key FFO/Debt credit metric on which these ratings agencies rely is projected to fall significantly below that 18 percent threshold in 2009 to **15.8 percent** without interim relief. *See* APS Exhibit 6.

There is little doubt that these facts collectively establish that, without interim rate relief, APS faces a significant likelihood that its credit will be downgraded to “junk” levels – a likelihood made even more pronounced given subsequent financial events. Indeed, at the hearing, witnesses for each and every party noted the effect of this evidence on their previous assessments of whether or not APS was at risk of a downgrade absent interim relief, particularly in light of the country’s economic decline. *See* Higgins Testimony at 279:3-11; Ahearn Testimony at 1064:25-1065:2; Cicchetti Testimony at 840:21-841:7; Parcell Testimony at 897:12-898:10; 908:18-24. Since then, several equity analyst reports published in reaction to the Recommended Order have expressly noted that if the Recommended Order is adopted and no interim relief is granted, “it almost certainly would heighten the risk of a credit downgrade by the rating agencies.” Citigroup Global Markets, Company Update, Pinnacle West Capital Corporation, November 13, 2008 (“ALJ Recommends no Interim Rate Relief”) (attached hereto at Tab 3).⁶ *See also* Dan Ford, Barclay’s Capital, November 14, 2008 PNW Company Update (“ALJ Recommends Against Interim Increase”) (denial of interim relief “would, in our view, put credit metrics at levels where the company would be at risk for downgrade”) (attached hereto at Tab 4).

⁶ APS requests that the Commission take judicial notice of these reports, which were published after the hearing in this matter and are publicly available, pursuant to Arizona Rule of Evidence 201 and A.A.C. R14-3-109(T)(5).

1 And the undisputed evidence makes clear that the consequences of a downgrade
2 to both APS and its customers are devastating, particularly in this market. Upon a
3 downgrade, financing costs, ultimately borne by customers, would increase
4 dramatically, assuming that the Company is able to access the financial markets at all as
5 a non-investment grade borrower (a dubious assumption, particularly in today's volatile
6 economic climate), thereby jeopardizing APS's ability to provide reliable service to
7 Arizona at reasonable prices. *See, e.g.,* Higgins Testimony at 248:18-250:9; Brandt
8 Testimony at 439:1-16; Smith Testimony at 683:15-684:20. At the time of the hearing,
9 the increased financing costs associated with a downgrade were estimated to be roughly
10 \$1 billion over the next ten years. *See* Brandt Affidavit at 13, Brandt Hearing
11 Testimony at 439:1-16. In other words, a failure to increase prices now means that
12 customers will be required to pay even higher prices later.
13

14 Moreover, if APS is downgraded by S&P to junk credit status, significant
15 projects that the Company wants and intends to undertake, like Solana, as well as the
16 Company's ability to comply with the Commission's Renewable Energy Standards will
17 be put at risk or made entirely impossible – a point well-recognized in the industry.
18 *See, e.g.,* Dan Ford, Barclay's Capital, Nov. 14, 2008 ("Given the further need for
19 collateral postings and the need to partner in PPAs for the execution of plants such as
20 the Solana solar facility, we believe that not only would customer rates be higher for a
21 significant period of time if a downgrade occurs, but the Renewable Portfolio Standards
22 set by the state of Arizona would also be at significant risk, given renewable
23 developers' likely unwillingness to partner with a sub-investment grade utility.").
24 Finally, a downgrade to junk credit standing could result in the Company being entirely
25 unable to raise equity, thus making unavailable yet another means of funding the
26 Company's capital spending program and maintaining its capital structure within
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1 appropriate levels. *See* Brandt Testimony at 129:18-130:23, 210:10-21; APS Brief at
2 19.

3 At the hearing, RUCO Director Ahearn testified that, for these reasons, a
4 downgrade to junk would be “very bad,” with consequences that are not only
5 “exceptionally detrimental” for customers, but that would endure over the long-term.
6 *See* Ahearn Testimony at 1064:1-16. AECC Witness Kevin Higgins – a witness
7 representing a number of APS commercial, industrial, and public agency customers –
8 agreed, expressly testifying that granting APS interim relief would be “reasonable,”
9 “warranted,” “prudent,” and “required,” and that failing to grant interim relief, if not
10 outright imprudent, in his opinion would nonetheless “not be the best decision.” *See*
11 Higgins Testimony at 248:18-250:9. Even the Recommended Order expressly
12 recognizes “the risk that a downgrade to non-investment grade credit rating could have
13 on APS and its ratepayers” and concludes that “it is in the long-term best interests of
14 APS and its customers that APS have access to capital at attractive rates in order to
15 fund needed future plant at reasonable cost,” *see* Recommended Order at 35 – interests
16 that will be totally undermined if APS suffers a downgrade to junk.
17

18 Under any definition, the undisputed fact that, without interim relief and in the
19 midst of a national financial crisis, APS and its customers are at some risk that these
20 consequences will result clearly establishes the existence of an “emergency,” even
21 under the Recommended Order’s narrow construction of that term. *See* Recommended
22 Order at 30 (noting that “an ‘emergency’ could be found to exist when the absence of
23 action would cause the emergency events to occur”). Yet the Recommended Order
24 offers no meaningful discussion of this critical evidence, focusing instead on whether
25 APS is **currently** insolvent, in a “cash flow crisis” or in danger of defaulting on
26 contracts (*see* Recommended Order at 31) – a concentration on overly narrow and
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1 antecedent circumstances that not only conflicts with its own articulation of what may
2 appropriately be deemed an “emergency” but that fails to consider the significant threat
3 that Arizona will suffer the unprecedented consequences of a downgrade of the State’s
4 largest utility to junk credit status if the Commission does not take proactive measures
5 now, rather than waiting until it is too late.

6 And although the Recommended Order notes that APS’s current ratings outlook
7 is “stable” and that only S&P rates APS just one notch above non-investment grade, its
8 recitation of these facts does not mention the undisputed evidence discussed at length
9 during the hearing that APS was downgraded by S&P to its current BBB- credit grade
10 on December 21, 2005 notwithstanding the fact that – **just five days earlier** – S&P had
11 published a lengthy and detailed article affirming the Company’s then similarly “stable”
12 credit outlook. *See* APS Exhibit 15. Like today, APS had a general rate case pending
13 at the time. *See id.* As one party to this proceeding perceptively pointed out, given this
14 evidence, it would be imprudent to rely on today’s “stable” outlook as a reason for
15 denying interim relief, for “those who ignore history are doomed to repeat it.” *See* AIC
16 Brief at 6. Indeed, given the current financial upheaval in the economy and with rating
17 agencies already subject to closer scrutiny under the Credit Rating Agency Reform Act
18 of 2006, 120 Stat. 1327, there is an even greater likelihood of a prompt downgrade if
19 APS’s financial metrics continue to decline.
20

21 Moreover, as discussed at length in APS’s post-hearing briefs, each and every
22 one of the credit rating agencies has publicly predicated its current “stable” outlooks of
23 the Company’s ratings on the prospect of interim relief. *See* APS Brief at 18.
24 Moody’s, for example, notes that its “stable” outlook **“contemplates recent ACC**
25 **decisions and regulatory activities that appear intended to reduce regulatory lag**
26 **and provide more timely recovery of costs,”** and specifically includes as one such
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28

1 **activity the potential for interim rate relief in this matter**, importantly noting that
2 “the ACC has granted interim increases in the recent past” and that “Moody’s views
3 mechanisms designed to reduce the time required to recover a utility’s costs, such as the
4 requested interim base rate increase, a positive for credit quality.” Staff Exhibit 2,
5 Attachment 6 at 2. These statements plainly indicate that a key driver of Moody’s
6 “stable” outlook and current rating for APS is the Company’s interim request and the
7 expectation that it may be granted.

8 Similarly, after specifically noting that “APS’s consolidated financial
9 performance will continue to be challenged by regulatory lag, which could be
10 moderated by APS’s interim rate request,” S&P expressly forewarned that APS’s
11 “[r]atings could be lowered to speculative grade if the company is not able to
12 overcome the challenge of ensuring timely recovery of its prudently incurred
13 costs,” and that, given such challenges, S&P sees “little potential for positive
14 movement in the rating or outlook.” *Id.* at 5. This written warning, in combination
15 with S&P’s expressed intent to reassess APS’s ratings in a ratings committee meeting
16 after a decision in this interim matter is announced, presents compelling evidence that
17 the Company faces a substantial risk of downgrade by S&P upon the conclusion of this
18 matter if interim relief is not permitted.

19 Neither should the fact that “only S&P” has APS on the precipice of downgrade
20 be used as justification to find that interim relief is inappropriate under these
21 circumstances, as the Recommended Order appears to suggest. *See Recommended*
22 *Order at 30.* Indeed, such an implication disregards without explanation the evidence
23 presented by Mr. Brandt, who has more than 25 years of experience working in a
24 financial capacity for regulated utilities and interacting with credit rating agencies, and
25 who specifically testified that “as a practical matter, if any one of the three major credit
26
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1 rating agencies downgrades APS [to junk], the Company's debt will be regarded as
2 junk by the market." Brandt Rebuttal Testimony (APS Exhibit 2) at 27. Thus, it will
3 make little difference if Moody's and Fitch rate APS as merely "near-junk" once S&P
4 downgrades the Company – the harm will have already occurred, which consequences
5 will take years to reverse. *See* Brandt Testimony at 502:21-503:10.

6 The evidence at the hearing thus clearly demonstrated that APS faces a severe
7 risk of a credit-rating downgrade – a risk that is even more likely today than it was
8 when APS first filed its Motion in light of current and forecasted financial market
9 conditions. Given the undisputed and dramatic consequences of a downgrade, there is
10 little question that APS has met any legal standard requiring the existence of an
11 "emergency," and that the Commission should use its plenary rate-making authority to
12 grant the Company the relief requested and prevent those consequences from occurring
13 before it is too late and the harm to APS, its customers, and, indeed, the State of
14 Arizona has already occurred.

15
16 **III. THE RECOMMENDED ORDER INCORRECTLY SPECULATES THAT**
17 **APS'S CURRENT FINANCIAL CRISIS COULD BE THE RESULT OF**
18 **INTERNAL FACTORS AND LACKS ANY BASIS FOR IMPOSING**
19 **ADDITIONAL REPORTING REQUIREMENTS ON THE COMPANY.**

20 Finally, despite the detailed evidence presented at the hearing, the
21 Recommended Order misunderstands the factors contributing to APS's current
22 financial crisis by asserting that the crisis "[t]o a large extent . . . is within APS'
23 control." Recommended Order at 35. As APS established at the hearing – through
24 largely undisputed evidence – affirmative and timely relief from the Commission is the
25 only means of **materially** improving the Company's financial metrics, remedying the
26 consequences of massive capital expenditures and related regulatory lag, and staving
27 off a credit-rating downgrade before the conclusion of the general rate case.

1 Despite the appeal of attributing APS's current situation on financial,
2 management, and operational decisions, the evidence presented at the hearing showed
3 that the Company cannot just "monitor its cash, adjust its expenditures, and seek an
4 equity infusion when needed and appropriate," as suggested by the Recommended
5 Order. *Id.* Indeed, such a conclusion directly contradicts the evidence presented in this
6 proceeding. For example, none of the parties refuted the fact that APS has incurred, but
7 not yet begun to recover in rates, hundreds of millions of dollars in capital investment
8 or demonstrate that any such investment was not critical to ensuring that the Company
9 can satisfy the growing energy needs in Arizona. *See* Brandt Rebuttal at 39; Rumolo
10 Rebuttal Attachment DJR_RB-1; Higgins Testimony at 298:12-299:5. Nor could any
11 of the parties refute the fact that, given such costs and the prolonged recovery of them,
12 APS has experienced a rapidly growing earnings shortfall – a fact that, in and of itself,
13 shows that APS shareholders are not only already "sharing the burden" of APS's
14 financial condition (as the Recommended Order suggests they should, *see*
15 Recommended Order at 36), but are in fact **shouldering** it, subsidizing customer rates
16 that do not cover the Company's true cost of service. Indeed, allowing APS to charge
17 fully cost-based rates is not a "burden" to customers, but the long-recognized "price"
18 that customers pay for the receipt of government-regulated service available to all
19 within a certificated service territory.
20

21 Moreover, APS has not experienced any of the hypothetical over-earning
22 contemplated by the Recommended Order on page 27, and in fact the evidence showed
23 that APS's rates have caused it to under-earn consistently for years. *See* Brandt
24 Affidavit at 7; Brandt Rebuttal Testimony at 3, 11; AIC Brief at 10. And in any case,
25 whether the Company may someday "over-earn" (a condition the Commission has the
26 same power to remedy as it does the Company's current under-earning, contrary to the
27
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1 Recommended Order's suggestion otherwise, see Recommended Order at 27) is
2 irrelevant to whether or not APS currently faces a financial crisis that warrants interim
3 relief.

4 Finally, none of the parties any longer believes that APS can or should seek an
5 equity infusion in its current circumstances or attempt to reduce dividends in light of
6 the state of the nation's financial markets when the Company's stock price is trading
7 well below book value. See Brandt Rebuttal Testimony 32-33; Smith Testimony
8 615:16-616:5 and 622:18-623:20; Staff Brief at 11 and 31-32; Higgins Testimony
9 268:14-269:10. As Mr. Brandt fully explained during the hearing, any attempt to
10 reduce dividends would only undermine the Company's ability to sell equity and raise
11 capital – particularly in the midst of the country's current financial crisis. *See, e.g.,*
12 Brandt Testimony 86:7-87:12, 97:9-98:7, 458:16-459:13.

14 The Recommended Order cites to no record evidence for the proposition that
15 APS's current financial crisis "is within APS' control" (*see* Recommended Order at
16 35), and does not acknowledge all the evidence to the contrary. Accordingly, APS
17 urges the Commission to reject such speculation and instead find that the evidence
18 presents a compelling case that unrecovered capital expenditures, which have been
19 made in furtherance of APS's obligation to meet customer needs, have caused the
20 Company extreme financial hardship that now threatens the Company's credit standing.

21 In short, the evidence from the hearing has already answered the questions posed
22 by the Recommended Order (*see* Recommended Order at 33), establishing precisely
23 why APS's financial metrics continue to suffer despite the PSA, transmission cost
24 adjustor, environmental impact surcharge, and other Commission-approved measures;
25 describing the significant cost-cutting and other efforts that the Company has already
26 taken in attempt to boost its declining financial condition; and confirming that
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28

1 remedying the crisis is beyond the Company's control if the Company is to continue to
2 maintain and expand its service infrastructure to meet customer demand. Although the
3 Company is willing to provide the Commission with the recommended reports (which
4 would, to some extent, be redundant information that APS already provides on a regular
5 basis, such as the capital structure and financial reports that APS is required to file
6 quarterly, describing the Company's debt and equity levels, earnings, ROE, and other
7 financial metrics), it strongly believes that such reporting requirements will not in any
8 way mitigate the risk that the Company will be downgraded without prompt action by
9 the Commission and will only increase the administrative burden on the Commission
10 and its Staff.

12 CONCLUSION

13 The interim relief that APS seeks is permissible under both well-established law
14 and the Commission's own articulated standards. The Commission's broad authority
15 allows it to grant interim relief under the circumstances facing APS even absent an
16 explicit finding of an "emergency" and despite the inability to conduct a full fair-value
17 analysis until the pending general rate case. In any event, APS's current financial crisis
18 and the attendant risk of a bond rating downgrade clearly constitute an emergency and
19 support interim relief under any potentially applicable "emergency" standard.

20 Granting APS the requested interim relief could well prevent the risk of
21 downgrade and the undisputed and catastrophic consequences of such an event from
22 materializing, and will go a long way towards ensuring that APS has the resources it
23 needs to secure a sustainable and renewable energy future for the State of Arizona.⁷ A
24

25 ⁷ While the Company supports the concept, the Recommended Order's suggestion that the Commission
26 should consider eliminating the 90/10 sharing provision in the PSA is not a sufficient substitute for the
27 relief APS has requested. Such a measure would produce only \$8 to \$10 million of annual pre-tax
28 revenue in 2009, an amount far short of what the Company needs to bolster its credit metrics and
prevent a downgrade to junk bond status.

1 roughly four mil increase that, if not later found supportable in the permanent rate case,
2 is fully refundable with interest to customers at the close of the general rate proceedings
3 is relatively inexpensive insurance against such a risk.

4 For the foregoing reasons, the Company respectfully requests that the
5 Commission adopt amendments to the Recommended Order attached hereto at Tab 1.

6 RESPECTFULLY SUBMITTED this 21st day of November, 2008.

7
8 PINNACLE WEST CAPITAL CORPORATION
9 LAW DEPARTMENT

10
11 
12

13 Thomas L. Mumaw

14 Meghan H. Grabel

15 OSBORN MALEDON, P.A.

16
17 /s/ William J. Maledon
18 William J. Maledon
19 Jeffrey Molinar

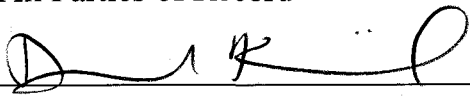
20 Attorneys for Arizona Public Service Company

21
22 ORIGINAL AND 13 COPIES OF THE FOREGOING
23 filed this 21st day of November, 2008 with:

24 Docket Control
25 Arizona Corporation Commission
26 1200 West Washington
27 Phoenix, AZ 85007
28

1 AND copies of the foregoing emailed or mailed
2 this 21st day of November, 2008 to:

3 All Parties of Record

4  _____

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Tab #1

APS PROPOSED AMENDMENT # 1
Docket No E-01345A-08-0172
(Motion for Interim Base Rate Increase)

Page 20 Line 23 to Page 36 Line 24:

DELETE: All

REPLACE WITH: “There is universal agreement amongst all the witnesses that a downgrade of APS to “junk” would be extremely costly to APS customers, at best, and a direct threat to future service quality and reliability, at its worst. No witness was able to objectively quantify the likelihood of such a downgrade in the absence of interim relief, but none could assure this Commission that the threat was as negligible as to be ignored.

Simply put, the risk of such financial emergency is too great to take unless there were no alternatives available to us. Fortunately, this Commission clearly has the authority to grant interim relief, not on a routine basis, as some have mischaracterized the Company’s argument, but upon the showing of special circumstances that in the absence of such relief, the potential harm to the public interest would be significant and, to some extent, irreversible. APS has demonstrated such special circumstances in this particular case.

Both Staff and AECC have urged that any grant of interim rate relief be for amounts less than the requested \$115 million. Given that we have concluded that it is appropriate to minimize the threat of further downgrade of APS debt securities, we do not believe half-measures are called for in such circumstances. Moreover, the making of this interim rate increase subject to refund (with interest) provides APS customers with protection against the possibility, however remote, that the permanent rate increase authorized in this docket will be less than \$115 million. Thus, we will approve the full \$115 million requested by the Motion.

Because the consequences of a downgrade to junk status would negatively impact the rates paid by APS customers, we believe further steps could be taken, consistent with the law, to improve APS’s cash flow and earnings in the short term while we examine in the general rate case the reasons for APS’s continuing poor financial performance. The current PSA has a 90/10 sharing provision that diminishes APS’s cash flow and earnings because APS is unable to collect ten percent of increased fuel and purchased power costs. It is a sharing mechanism imposed on no other electric utility under our jurisdiction. In APS’s last rate case we maintained that provision in order to provide APS incentive to acquire the most economical resources. The results of the recent fuel audit confirm that APS has managed its resource acquisitions appropriately. Recognizing that it is to the long-term benefit of Arizona and APS customers for APS to maintain a healthy financial condition, as the costs for future plants, generation, materials, capital, and service will be affected by APS’s ability and costs to access the financial markets, we would be willing to address any appropriate motion or request pursuant to A.R.S. § 40-252 to modify the

PSA to eliminate the 90/10 sharing until the permanent rate case where we could evaluate and resolve whether the sharing mechanism is causing or significantly contributing to the FFO/Debt ratio decline.

In the general rate proceeding, we expect the parties to address this issue and to recommend whether the same or another sharing mechanism or other such incentive should be adopted as part of the PSA on a going forward basis. Although this PSA modification would have only a small positive effect on APS's cash flow and its FFO/Debt ratio, our willingness to consider it further demonstrates that we are monitoring APS's financial condition and are prepared to take additional appropriate measures to address the risks that APS and its customers are facing.

We now turn to two other issues: (1) how to allocate the interim increase; and (2) the provisions for refunds and interest. We find the arguments of AECC to be most persuasive in this case and will require that the interim increase be implemented through an equal percentage increase on all base rate elements. **[OR: "We find the arguments of Staff and RUCO to be most persuasive in this case and will require that the interim increase be implemented on an equal cents per kWh basis."]** Consistent with the Company's request and the agreement of the other parties, Rate Schedules E-3 and E-4 (low income and medically-dependent customers) will be exempted from this interim increase. The increase should be subject to refund at the rate generally required for customer advances per A.A.C. R14-2-203 (B) (3). Any potential refund will be allocated to customer classes in equal percentage proportion. **[OR: "Any potential refund will be distributed on an equal cents per kWh basis."]."**

Page 39 Line 1:

DELETE: "not".

REPLACE: "or" with "and".

DELETE: Findings of Fact Nos. 26 through 32 and renumber accordingly.

DELETE: Finding of Fact Nos. 37, 38 and 39.

Page 40 Line 26:

DELETE: "No".

REPLACE WITH: "An".

Page 40 Line 27:

DELETE: "not".

Page 40 Line 28:

DELETE: “denied without prejudice.”

REPLACE WITH: “granted effective January 1, 2009 in accordance with the discussion herein.”

Page 41 Line 2:

DELETE: “denied without prejudice.”

REPLACE WITH: “granted effective January 1, 2009 in accordance with the discussion herein.”

Page 41 Lines 4 through 18:

DELETE: All

Page 42 Lines 1 through 3:

DELETE: All

MAKE ALL CONFORMING CHANGES.

Tab #2

North America United States
 Industrials Utilities and Power

13 November 2008

Pinnacle West Capital

Reuters: **PNW.N** Bloomberg: **PNW UN** Exchange: **NYS** Ticker: **PNW**

Regulatory environment still negative in AZ

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ALJ recommends zero interim rate relief

The ALJ recommended no interim rate increase versus the \$115MM requested PNW rate increase. PNW has stated that even if the interim rate case does not provide relief, its reduced capex budget should allow it to not have to issue equity in '08 or '09. While we like PNW's strategy to reduce capex (due to slowing growth) and realize a higher ROE, we are cautious of the regulatory environment in AZ and are concerned the ACC could pressure PNW to issue equity or cut its dividend as part of a GRC decision. Maintain Hold; lower PT to \$29.

Regulatory and recovery treatment increases cost of capital

To us it appears that the ALJ took more of a legalistic approach citing no pending "emergency", despite arguments by APS and other intervenors (AZ Investment Council, AECC, Mesquite Group) that an "emergency" does not have to exist to grant interim rate relief. We believe this was a good opportunity for the ALJ at the ACC to support APS' creditworthiness (BBB- at S&P, one notch above junk) and ability to attract capital at reasonable rates. We find it hard to see why anyone would want to own APS debt or the equity of PNW with this type of regulatory treatment and recovery in AZ. Potentially in APS' favor, 3 of the 5 commissioners of the ACC will be replaced in January 2009, based on the final results of the general election.

Reduced capex and ample liquidity helps PNW near term

Due to reducing its capex budget by ~\$520MM in '09, PNW has delayed its near term common equity issuances for '08 and '09. While we are concerned the outcome of the GRC could force equity issuance or a dividend cut, we assume PNW does not issue equity until 1Q '10 for modeling purposes. PNW's near term liquidity and credit availability is healthy. PNW currently has \$708MM of revolver capacity and \$105MM of cash and no major debt maturities until 2011. As has been the case for '08, we expect almost all of PNW's earnings in '09 to be from APS, with SunCor to have minimal contribution due to the slowing AZ economy and poor real estate environment. Our new '08- '12 EPS estimates are \$2.43, \$2.45, \$2.79, \$3.02 and \$3.18, respectively.

Valuation and risks

Our PT is based on a combination of our SOP and comparable multiples analyses. Upside/downside risks: more/less favorable than anticipated regulatory developments at APS (see pg 8 for details).

Forecasts and ratios

Year End Dec 31	2006A	2007E	2008E
1Q EPS ¹	0.13	0.16	-0.04
2Q EPS	1.03	0.78	1.03
3Q EPS	1.84	1.99	1.50
4Q EPS	0.14	0.03	-0.05
FY EPS (USD)	3.13	2.96	2.43

Source: Deutsche Bank estimates, company data

¹ Includes the impact of FAS123R requiring the expensing of stock options.

Deutsche Bank



Forecast change

Hold

Price at 12 Nov 2008 (USD)	28.98
Price target	29.00
52-week range	44.24 - 28.20

Key changes

Price target	34.00 to 29.00	↓	-14.7%
EPS (USD)	2.94 to 2.96	↑	0.8%
Revenue (USDm)	3,522.9 to 3,523.6	↑	0.0%

Price/price relative

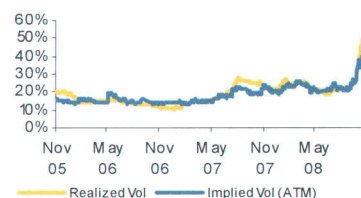


Performance (%)	1m	3m	12m
Absolute	0.1	-17.0	-30.5
S&P 500 INDEX	-5.2	-33.9	-40.8

Stock & option liquidity data

Market cap (USDm)	2,921.1
Shares outstanding (m)	100.8
Free float (%)	100
Volume (12 Nov 2008)	326,100
Option volume (und. shrs., 1M avg.)	7,270
Short interest (m)	—
Short interest (%)	—
Institutional ownership (%)	—
DPS (USD)	2.10

Implied & Realized Volatility (3M)



Implied Volatility (3M, ATM) vs. Peers

OKEN	60.9%
PSDN	59.9%
AWK	47.7%
LNT.N	46.9%
PNW.N	37.3%

*Weighted-avg. of index components
 Data as of 12-Nov-08

Deutsche Bank Securities Inc.

All prices are those current at the end of the previous trading session unless otherwise indicated. Prices are sourced from local exchanges via Reuters, Bloomberg and other vendors. Data is sourced from Deutsche Bank and subject companies. Deutsche Bank does and seeks to do business with companies covered in its research reports. Thus, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Independent, third-party research (IR) on certain companies covered by DBSI's research is available to customers of DBSI in the United States at no cost. Customers can access IR at <http://gm.db.com> or by calling 1-877-208-6300. DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1.



Updating our work on PNW

Because we are concerned PNW may be forced by the ACC to issue equity in late 2009 or cut its dividend, we prefer UNS as a better play on Arizona.

Regulatory difficulty with ACC could persist

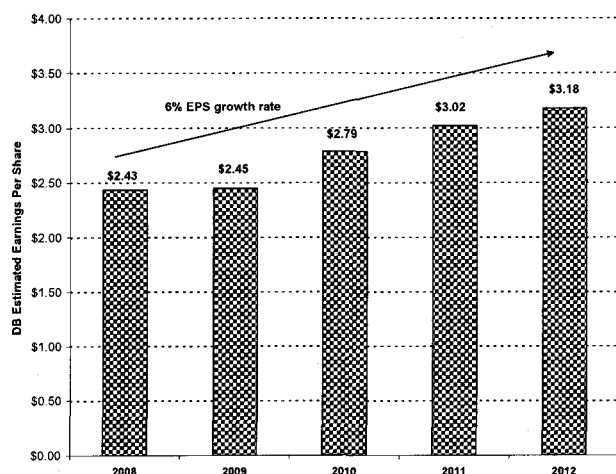
With ~6-7% of potential EPS growth based on outcomes of regulatory cases and a reduced capex budget in-line with a slowing Arizona economy, PNW is positioned for steady growth over the long term. That said, we continue to be highly cautious of the regulatory environment in Arizona. We are not very bullish on the outcomes of the interim and general rate cases that the company has filed through its regulated utility, Arizona Public Service (APS), especially given today's ALJ recommended order on the APS interim rate case. While we like PNW's strategy to reduce capex and equity financing, and to aim to reduce regulatory lag and realize a higher ROE at Arizona Public Service, we are concerned that the ACC could pressure APS to issue equity or cut its dividend as part of a GRC decision.

Because of the aforementioned concern, we prefer UNS as a better play on Arizona. Potentially in APS' favor, 3 of the 5 commissioners of the Arizona Corporation Commission (ACC) will be replaced in January 2009, based on the final results of the general election. We have reduced our estimates slightly for PNW to reflect reduced capital expenditures and an unlikely positive outcome for the interim rate case. We maintain our Hold rating and lower our price target on PNW shares to \$29 based on reduced estimates and lower group multiples.

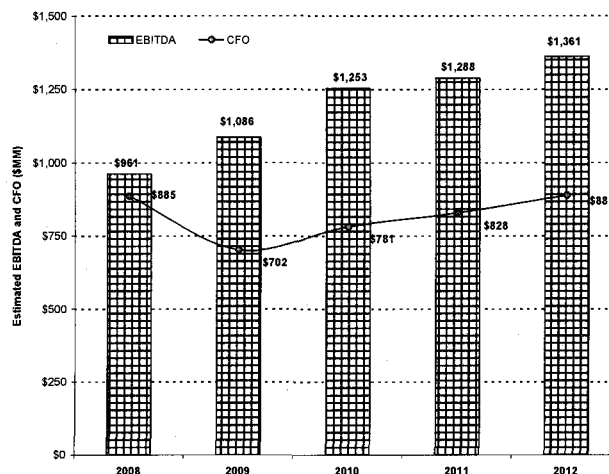
We believe this was a good opportunity for the ALJ at the ACC to support APS creditworthiness and ability to attract capital at reasonable rates. We find it hard to see why anyone would want to own APS debt or the parent equity of PNW with this type of regulatory treatment and recovery in the state of Arizona.

Negative outcome for ALJ interim rate case decision

The ALJ recommended no interim rate increase versus the \$115 million requested APS rate increase and encouraged APS to show how it can improve its FFO/Debt ratio in the General Rate Case. The ALJ also recommended that the APS analysis show steps that may be taken in the future to increase cash including dividend reductions, elimination of management bonuses, and other measures that would require stockholders to share the burden with ratepayers. To us it appears that the ALJ took more of a legalistic approach citing no pending "emergency", despite arguments by APS and other intervenors (AZ Investment Council, AECC, Mesquite Group) that an "emergency" does not have to exist to grant interim rate relief. We believe this was a good opportunity for the ALJ at the ACC to support APS creditworthiness (BBB- at S&P, one notch above junk) and ability to attract capital at reasonable rates. We find it hard to see why anyone would want to own APS debt or the parent equity of PNW with this type of regulatory treatment and recovery in the state of Arizona.

Figure 1: 2008-2012 EPS estimates for PNW

Source: Deutsche Bank

Figure 2: 2008-2012 PNW EBITDA and CFO estimates

Source: Deutsche Bank

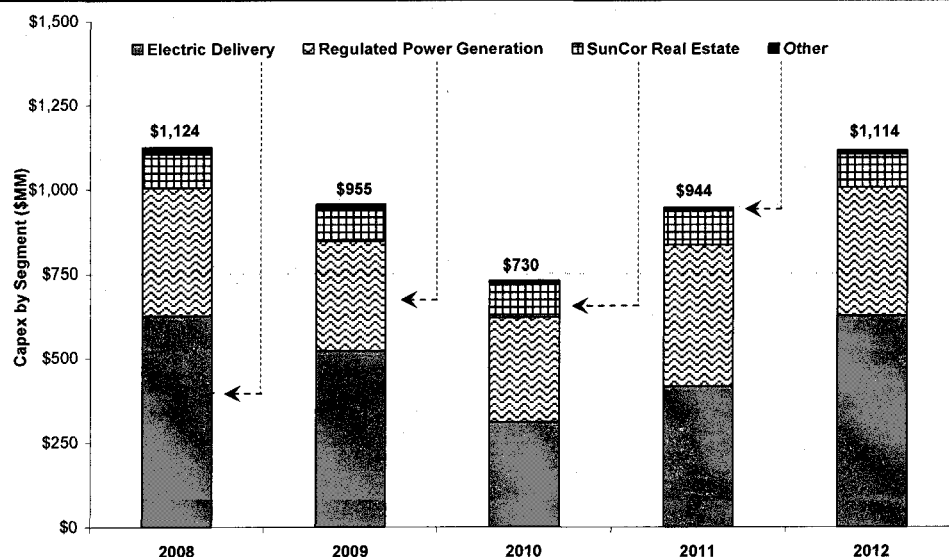
As shown in Figure 1 above, our new estimates for 2008, 2009, 2010, 2011 and 2012 are \$2.43, \$2.45, \$2.79, \$3.02 and \$3.18, respectively. Figure 2 highlights our estimates for EBITDA and cash flow from operations from 2008 to 2012. We estimate PNW's EBITDA to be \$961 million in 2008, \$1.1 billion in 2009, \$1.3 billion in 2010, \$1.3 billion in 2011 and \$1.4 billion in 2012. We expect cash flow from operations to be relatively flat over the years with it to be \$885 million in 2008, \$702 million in 2009, \$781 million in 2010, \$828 million in 2011 and \$888 million in 2012.

Update on capital expenditures and liquidity

PNW recently reiterated its 2008 EPS guidance of a reasonable range around \$2.50, in line with our estimate of \$2.43 per share. As has been the case for 2008, we expect almost all of PNW's earnings in 2009 to be from APS, with SunCor to have minimal contribution due to the slowing Arizona economy and poor real estate environment.

The company expects a very weak 1% growth in its customer base over the next two years.

The company recently provided more detail on the gross \$720 million capital expenditure reductions for its ~\$3 billion capex budget over the next 3 years. Approximately 80% of the \$720 million of reductions relate to slowing of customer growth and 20% are delays of capital projects. In addition, the \$720 million of capital expenditure reductions include \$200 million in recoverable capital costs for building transmission lines to new developments. The company expects a very weak 1% annual growth in its customer base over the next two years.

Figure 3: 2008-2012 PNW Capex by Segment

Source: Deutsche Bank

PNW does not have any major debt maturities until 2011 and SunCor debt does not have any cross-default with PNW.

Due to its reduced capital expenditure budget, PNW has delayed its near term common equity issuances for 2008 and 2009. The company has stated that even if the interim rate case does not provide rate relief, its reduced capex budget should allow PNW to not have to issue equity in 2008 or 2009. That said, depending on the outcome of the GRC, we believe the company may have to issue equity as early as 1Q 2010 unless the ACC pressures it otherwise. PNW's near term liquidity and credit availability is healthy. PNW currently has a \$300 million revolver at the parent, and an aggregate \$900 million revolver at APS. While PNW has lost \$51 million of capacity from Lehman commitments, it still has \$708 million of revolver capacity and \$105 million of cash. In addition, PNW does not have any major debt maturities until 2011 and SunCor debt does not have any cross-default with PNW.

It is unclear whether a Republican or Democratic majority will be more constructive for the ACC, but we believe that a focus on reducing regulatory lag and maintaining an investment grade rating for APS will be constructive for PNW.

Arizona Corporation Commission: 3 new commissioners to start in January 2009

Commissioners in Arizona are elected to 4-year terms on the ACC. This year, 3 of the 5 Commissioners' (Commissioners Gleason, Mundell and Hatch-Miller) terms are expiring in January 2009. Commissioners Mayes and Pierce's terms expire in January 2011. At the current elections, Democrats Sandra Kennedy and Paul Newman have been elected to the commission. For the final position, votes for Democrat Sam George and Republican Bob Stump are still being counted, with Bob Stump currently slightly ahead. The three Democrats ran on a renewables platform, supporting renewable energy mandates; currently all 5 commissioners are Republicans. It is unclear whether a Republican or Democratic majority will be beneficial for the ACC, but we believe that a focus on reducing regulatory lag and maintaining an investment grade rating for APS would be constructive for PNW.

PNW Regulatory Update

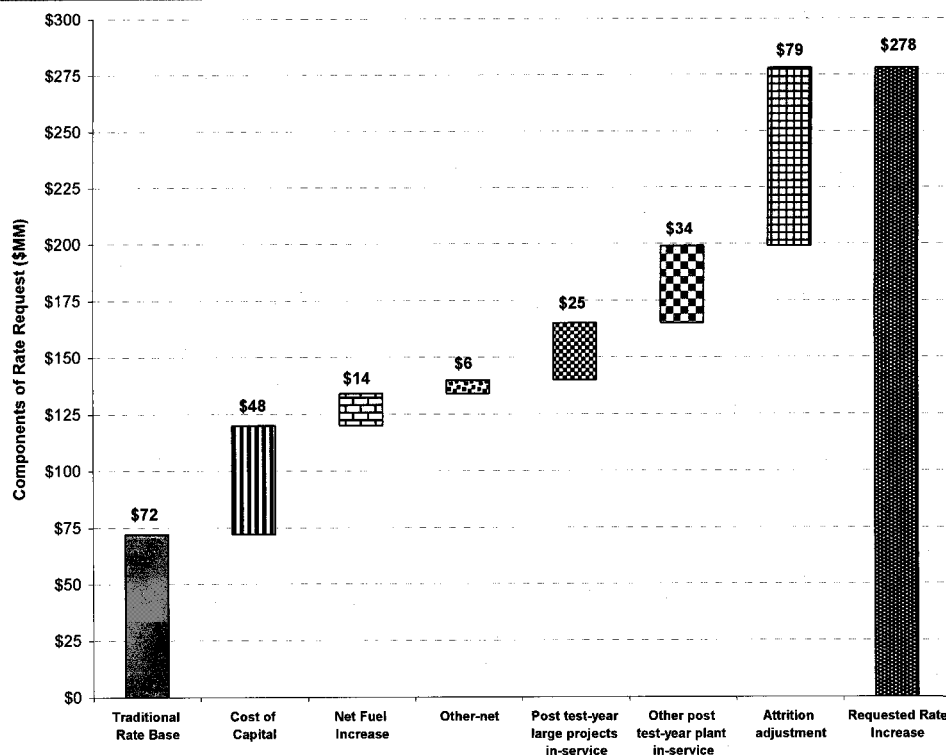
APS hopes to recover costs and improve ROE with its latest rate case

The \$278 million rate increase is based on a test year ended December 31, 2007, and a rate base of \$5.4 billion, an equity ratio of 54.1% and an 11.5% ROE.

In late March 2008, APS filed its GRC with the ACC. The utility has included several proposals to mitigate regulatory lag and proposed projects as part of its test-year. The \$278 million rate increase is based on a test year ended December 31, 2007, and a rate base of \$5.4 billion, an equity ratio of 54.1% and an 11.5% ROE. The company has said that it is open to settlement discussions with the ACC and its Staff as well.

The \$278 requested million rate increase has the following components shown in Figure 4:

Figure 4: Components of Rate Request Increase



Source: Deutsche Bank

APS is hoping to mitigate regulatory lag and earnings attrition through the following: post-test year plant additions, an attrition adjustment to capture revenue shortfall and a removal of disincentives to the energy efficiency programs.

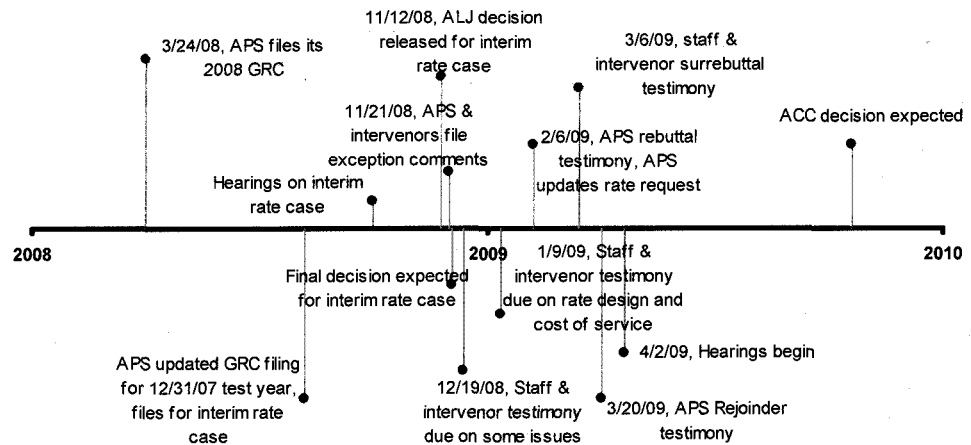
APS is hoping to mitigate regulatory lag and earnings attrition through the following: post-test year plant additions (projects planned to be in-service by the time rates go into effect), an attrition adjustment to capture revenue shortfall and a removal of disincentives to the energy efficiency programs. In addition, components such as net fuel increase and the attrition adjustment will be updated to reflect current fuel prices and earnings shortfall.

In addition, in June 2008, APS requested an interim base rate increase. It is seeking approximately \$115 million of the overall \$278 million increase from the GRC. This increase would be subject to refund, pending the outcome of the base rate case in the fall of 2009. Hearings were concluded for the interim rate relief in mid-September 2008. ACC Staff has recommended no rate increase, but has said that if the ACC wants to grant an increase it should be \$65MM. The ALJ recommended zero rate increase, feeling the company did not

qualify for emergency rate relief. A final ACC decision is expected before year end 2008. Staff had recommended that PNW issue equity as a precondition for rate relief, but has since backed off any preconditions.

Figure 5 highlights the current schedule of the interim rate case and APS rate case.

Figure 5: Regulatory Calendar for APS rate case



Source: Deutsche Bank

For the interim rate case and \$115 million increase requested by APS:

- **11/12/2008:** The ALJ released the recommended order of the interim rate case for APS.
- **11/21/2008:** APS and other intervenors file exception comments to the ALJ recommended order.
- The ACC decision could come anytime after the comments have been submitted; PNW expects the decision before year end. The Commission must consider the full record along with the ALJ recommended order and the exception comments from the parties.

For the General Rate Case:

- **12/19/2008:** Staff and intervenor testimony is due to all issues except rate design and cost of service
- **1/9/2009:** Staff and intervenor testimony is due on rate design and cost of service
- **2/6/2009:** APS rebuttal testimony due, APS will likely update its rate request mainly for fuel cost increase and attrition adjustment.
- **3/6/2009:** Staff and intervenor surrebuttal testimony due
- **3/20/2009:** APS rejoinder testimony is due
- **4/2/2009:** Hearings begin in GRC

We expect a final decision for the APS GRC in the late 3Q 2009 timeframe, highlighting how long it takes to realize higher rates in Arizona.

PNW earnings and cash forecasts

Our new and somewhat lower 2008, 2009, 2010, 2011 and 2012 EPS estimates are \$2.43, \$2.45, \$2.79, \$3.02 and \$3.18, respectively.

Figures 6 and 7 highlight our forecast for PNW and a summary of the major drivers and assumptions used in our estimates. Our new and somewhat lower 2008, 2009, 2010, 2011 and 2012 EPS estimates are \$2.43, \$2.45, \$2.79, \$3.02 and \$3.18, respectively. We have adjusted our model for the following:

- Assume no interim rate relief for 2009.
- Reduced our customer growth projections to 1% for 2009 and 2010 and 1.25% for 2011
- Increased our O&M expense projections for 2009, 2010 and 2011 assuming increased bad debt expense and other costs
- Assume a \$300 million equity offering in 1Q 2010.

Figure 6: Summary of PNW Financial Forecast

<u>Financial Summary</u>	2008E	2009E	2010E	2011E	2012E
EPS	\$2.43	\$2.45	\$2.79	\$3.02	\$3.18
FCF to Equity/Share	(\$1.68)	(\$2.50)	\$0.46	(\$1.05)	(\$1.95)
Diluted Shares Outstanding	101	101	110	110	116
EPS Growth	-18%	1%	14%	8%	5%
Dividend Payout Ratio	86%	87%	80%	76%	75%
<u>(\$ in Millions)</u>					
Cash Flow from Operations	\$885	\$702	\$781	\$828	\$888
Unlevered Free Cash Flow	(39)	(74)	237	73	(27)
FCF to Equity	(169)	(253)	51	(116)	(226)
EBITDA	961	1,086	1,253	1,288	1,361
EBIT	536	650	759	798	866
Year End Cash Balance	95	128	234	364	310
Net GAAP Debt	3,949	4,416	4,311	4,681	4,934
<u>Corporate Level Returns</u>					
Return on Assets	2.1%	2.0%	2.4%	2.5%	2.7%
Return on Capital Employed	4.6%	5.2%	5.8%	5.7%	5.9%
Return on Equity	6.9%	6.9%	7.8%	8.3%	8.4%

Source: Deutsche Bank

Figure 7: Highlights of PNW Model Drivers

	2008E	2009E	2010E	2011E	2012E
<u>Customer Growth</u>					
Residential & Small Business	1.0%	1.0%	1.0%	1.3%	2.0%
<u>Plant Capacity</u>					
Nuclear	1,147	1,147	1,147	1,147	1,147
Coal	1,741	1,741	1,741	1,741	1,741
Gas & Other	3,290	3,290	3,290	3,290	3,290
<u>Financial Drivers</u>					
Effective Tax Rate	34%	34%	35%	35%	35%
Realized Cash Tax Rate	-42%	31%	32%	31%	32%
Dividends per Share	\$2.10	\$2.12	\$2.23	\$2.30	\$2.40
<u>Capital Spending (\$ in Millions)</u>					
Electric Delivery	\$626	\$521	\$309	\$416	\$626
Power Generation	379	325	311	418,551	378,551
SunCor	100	90	100	100	100
Other	20	20	10	10	10
Total Capital Spending	\$1,124	\$955	\$730	\$944	\$1,114

Source: Deutsche Bank

PNW valuation

We value APS using an 11.75x EPS multiple, within the company's peer group range.

Maintain Hold rating and lower price target to \$29 per share

Our \$29 price target on PNW shares is based on our sum-of-the-parts and comparable multiples analyses. We value APS using an 11.75x EPS multiple, slightly higher than the company's peer group due to its attractive dividend. Figure 8 shows our sum-of-the-parts valuation for PNW.

Figure 8: PNW 2009E Sum-of-the-Parts Valuation

Business Segment	Valuation Metric	Low Case			Base Case		High Case	
		2010E	Multiple	Valuation (\$s MM)	Multiple	Valuation (\$s MM)	Multiple	Valuation (\$s MM)
APS Segment	EPS	\$2.83	11.00x	\$3,140	11.75x	\$3,355	12.50x	\$3,569
Total APS ST + LT debt				4,120		4,120		4,120
Parent & Other	EPS	(0.20)	11.00x	(222)	11.75x	(237)	12.50x	(253)
Exp. of Legacy Parent Trading Contract	EPS	(0.14)	11.00x	(156)	11.75x	(166)	12.50x	(177)
SunCor	Book Value	400	0.50x	200	0.75x	300	1.00x	400
Total PNW Asset Value				\$7,082		\$7,371		\$7,659
(Figures are 12/31/2009E)								
On-Balance Sheet Debt				\$4,545		\$4,545		\$4,545
Less: PV of Operating Leases				-		-		-
Less: Year End Cash Balance				(128)		(128)		(128)
Total Net Debt				\$4,416		\$4,416		\$4,416
PNW Equity Value				\$2,666		\$2,954		\$3,243
Fully Diluted Outstanding Shares				101		101		101
Implied Equity Value per Share				\$26		\$29		\$32

Source: Deutsche Bank

We believe the regulatory environment remains challenging in Arizona, which could create longer term risks in cost recovery for APS, in our view.

We believe the regulatory environment remains challenging in Arizona, which could create longer term risks in cost recovery for APS, in our view. We think that PNW's management team will ultimately be able to successfully navigate its GRC and mitigate some earnings attrition and operational issues, but believe regulatory pressure and overhangs could persist in the company's service territory.

PNW risk factors

Over the last several periods APS rates have increased, largely due to higher natural gas and power prices, creating some regulatory pressure. Because of the rising natural gas and power price environment, we believe the Arizona Corporation Commission (ACC), which is an elected state utility commission, may be reluctant to grant rate increases for APS in the future. Risks to our Hold rating include better- or worse-than-expected regulatory developments at APS.

Figure 9: PNW Income Statement

PNW Income Statement (\$ in MM, Except per Share Data)	2008E					2009E					2010E				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
Electric	\$623	\$829	\$1,040	\$628	\$3,121	\$640	\$850	\$1,066	\$642	\$3,199	\$658	\$875	\$1,097	\$661	\$3,291
Marketing and Trading	57	51	12	22	141	167	73	24	22	286	169	74	24	22	289
Real Estate	48	37	19	8	112	50	29	9	8	96	52	30	17	15	114
Other Revenue	9	9	9	-	27	-	-	-	-	-	-	-	-	-	-
Total Revenue	\$737	\$926	\$1,080	\$658	\$3,401	\$857	\$952	\$1,100	\$673	\$3,581	\$880	\$978	\$1,138	\$698	\$3,694
Fuel and Purchased Power	321	373	429	237	1,360	301	373	461	253	1,387	288	339	411	234	1,271
Gross Margin	\$416	\$553	\$650	\$421	\$2,041	\$556	\$579	\$639	\$420	\$2,194	\$592	\$640	\$727	\$464	\$2,423
Utility Operations and Maintenance	194	195	212	206	808	\$209	201	195	229	833	215	207	201	236	858
Real Estate Operations	48	42	29	7	126	37	22	7	6	72	37	21	12	10	80
Taxes Other Than Income Taxes	33	33	28	19	114	34	46	65	14	158	37	55	78	19	189
Other Expenses	6	7	8	11	32	11	11	11	11	44	11	11	11	11	44
EBITDA	\$134	\$277	\$372	\$178	\$961	\$286	\$299	\$361	\$160	\$1,086	\$293	\$346	\$426	\$188	\$1,253
Depreciation and Amortization	96	98	99	106	398	111	111	111	111	444	115	115	115	115	460
Operating Income	\$39	\$179	\$274	\$72	\$564	\$155	\$188	\$250	\$49	\$643	\$178	\$231	\$311	\$73	\$793
Allowance for Equity During Construction	6	5	5	8	24	5	5	5	5	20	5	5	5	5	20
Other Utility Income/(Expense)	(1)	(6)	(5)	(30)	(42)	(6)	(6)	(6)	(6)	(24)	(35)	(10)	(10)	(10)	(65)
Preferred Stock Dividend Req. of APS	-	-	-	-	-	4	4	4	4	14	4	4	4	4	14
Net Other Income/(Expense)	0	(11)	1	-	(9)	(1)	(1)	(1)	(1)	(3)	(1)	(1)	(1)	(1)	(3)
Total Other Income	\$5	(\$11)	\$1	(\$22)	(\$27)	\$2	\$2	\$2	\$2	\$7	(\$27)	(\$2)	(\$2)	(\$2)	(\$34)
EBIT	\$44	\$168	\$275	\$50	\$536	\$157	\$190	\$252	\$51	\$650	\$151	\$229	\$309	\$71	\$759
Interest Expense	55	52	51	62	220	69	71	73	74	287	77	73	74	73	298
Capitalized Interest	(6)	(5)	(4)	(4)	(19)	(3)	(3)	(3)	(3)	(12)	(3)	(3)	(3)	(3)	(12)
Earnings Before Taxes	(\$5)	\$121	\$227	(\$8)	\$335	\$91	\$122	\$182	(\$20)	\$375	\$76	\$158	\$238	\$1	\$473
Effective Tax Rate	N/A	14.1%	33.4%	34.0%	26.8%	34.0%	34.0%	34.0%	34.0%	34.0%	35.0%	35.0%	35.0%	35.0%	35.0%
Income Tax Expense/(Benefit)	(1)	17	76	(3)	90	31	41	62	(7)	127	27	55	83	0	166
Recurring Net Income	(\$4)	\$104	\$152	(\$5)	\$246	\$60	\$80	\$120	(\$13)	\$247	\$50	\$103	\$155	\$1	\$308
Diluted Outstanding Shares	101	101	101	101	101	101	101	101	101	101	110	110	110	110	110
Recurring Earnings per Share	(\$0.04)	\$1.03	\$1.50	(\$0.05)	\$2.43	\$0.59	\$0.79	\$1.19	(\$0.13)	\$2.45	\$0.45	\$0.93	\$1.40	\$0.01	\$2.79

Source: Deutsche Bank



Figure 10: PNW Cash Flow statement

PNW Cash Flow Statement																					
(\$ in MM, Except per Share Data)							2009E					2010E					2011E				
		2Q	2Q	FY	FY		2Q	2Q	2Q	FY		2Q	2Q	2Q	FY		2Q	2Q	2Q	FY	
Income from Continuing Operations	(\$4)	\$134	\$152	(\$5)	\$276	\$60	\$80	\$120	(\$13)	\$247	\$50	\$103	\$155	\$1	\$308						
Depreciation and Amortization	104	105	161	106	476	111	111	111	111	444	115	115	115	115	460						
Deferred Income Taxes	(45)	199	74	1	229	3	3	4	1	11	3	4	5	1	13						
Changes in Working Capital	(3)	(40)	21	(23)	(73)	-	-	-	-	-	-	-	-	-	-						
Other	194	36	(303)	-	(73)	-	-	-	-	-	-	-	-	-	-						
Cash Flow from Operations	\$246	\$433	\$105	\$101	\$885	\$173	\$195	\$236	\$99	\$702	\$167	\$222	\$275	\$117	\$781						
CFO Excl. Working Capital	\$249	\$474	\$84	\$101	\$908	\$173	\$195	\$236	\$99	\$702	\$167	\$222	\$275	\$117	\$781						
Capital Expenditures	(\$248)	(\$229)	(\$189)	(\$457)	(\$1,124)	(\$239)	(\$239)	(\$239)	(\$239)	(\$955)	(\$182)	(\$182)	(\$182)	(\$182)	(\$730)						
Acquisitions of Assets & Securities	-	(199)	199	-	-	-	-	-	-	-	-	-	-	-	-						
Divestitures of Assets & Securities	-	282	(282)	-	-	-	-	-	-	-	-	-	-	-	-						
Other, Net	0	14	55	-	70	-	-	-	-	-	-	-	-	-	-						
Cash Flow from Investing	(\$248)	(\$131)	(\$218)	(\$457)	(\$1,054)	(\$239)	(\$239)	(\$239)	(\$239)	(\$955)	(\$182)	(\$182)	(\$182)	(\$182)	(\$730)						
Issuance/(Redemption) of Debt	\$16	(\$175)	\$168	\$400	\$410	\$300	\$0	\$0	\$200	\$500	\$0	\$0	\$0	\$0	\$0						
Issuance/(Rep.) of Common Equity	-	6	3	-	8	-	-	-	-	-	300	-	-	-	300						
Issuance/(Rep.) of Preferred Equity	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-						
Common Stock Dividends	(53)	(53)	(53)	(53)	(212)	(54)	(54)	(54)	(54)	(214)	(61)	(61)	(61)	(61)	(246)						
Other Financing	0	(1)	3	-	2	-	-	-	-	-	-	-	-	-	-						
Cash Flow from Financing	(\$36)	(\$223)	\$121	\$347	\$208	\$246	(\$54)	(\$54)	\$146	\$286	\$239	(\$61)	(\$61)	(\$61)	\$54						
Increase/(Decrease) in Cash	(\$39)	\$79	\$8	(\$9)	\$39	\$181	(\$98)	(\$57)	\$6	\$33	\$223	(\$22)	\$31	(\$127)	\$105						
Cash at Beginning of Period	56	18	97	105	56	95	276	179	122	95	128	352	330	361	128						
Cash at End of Period	\$18	\$97	\$105	\$95	\$95	\$276	\$179	\$122	\$128	\$128	\$352	\$330	\$361	\$234	\$234						
Free Cash Flow Calculations																					
Unlevered Free Cash Flow	\$29	\$333	(\$82)	(\$319)	(\$39)	(\$22)	\$0	\$42	(\$94)	(\$74)	\$33	\$85	\$138	(\$20)	\$237						
FCF, Excl. Acquis. & Divest.	\$29	\$249	\$2	(\$319)	(\$39)	(\$22)	\$0	\$42	(\$94)	(\$74)	\$33	\$85	\$138	(\$20)	\$237						
FCF to Equity Holders, Excl. Acq.	(\$3)	\$218	(\$29)	(\$356)	(\$169)	(\$65)	(\$44)	(\$3)	(\$140)	(\$253)	(\$15)	\$39	\$92	(\$66)	\$51						
FCF to Equity per Share	(\$0.03)	\$2.16	(\$0.29)	(\$3.53)	(\$1.68)	(\$0.65)	(\$0.44)	(\$0.03)	(\$1.39)	(\$2.50)	(\$0.14)	\$0.36	\$0.84	(\$0.59)	\$0.46						

Source: Deutsche Bank

Figure 11: PNW Balance Sheet

PNW Balance Sheet

(\$s in MM, Except Where Noted)

	2008					2007					2006				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
Cash and Cash Equivalents	\$18	\$97	\$105	\$95	\$95	\$276	\$179	\$122	\$128	\$128	\$352	\$330	\$361	\$234	\$234
Accounts Receivable	389	501	549	549	549	549	549	549	549	549	549	549	549	549	549
Inventory	189	265	191	191	191	191	191	191	191	191	191	191	191	191	191
Other Current Assets	310	173	155	155	155	155	155	155	155	155	155	155	155	155	155
Total Current Assets	\$906	\$1,036	\$1,000	\$990	\$990	\$1,172	\$1,074	\$1,017	\$1,023	\$1,023	\$1,247	\$1,225	\$1,256	\$1,129	\$1,129
Gross PP&E	\$12,559	\$12,730	\$12,895	\$13,352	\$13,352	\$13,591	\$13,830	\$14,069	\$14,308	\$14,308	\$14,490	\$14,672	\$14,855	\$15,037	\$15,037
Less Accumulated Depreciation	4,016	4,057	4,110	4,216	4,216	4,327	4,438	4,549	4,660	4,660	4,775	4,890	5,004	5,119	5,119
Total PP&E	\$8,543	\$8,673	\$8,785	\$9,136	\$9,136	\$9,264	\$9,392	\$9,520	\$9,648	\$9,648	\$9,715	\$9,783	\$9,850	\$9,918	\$9,918
Investments	\$961	\$1,116	\$821	\$821	\$821	\$821	\$821	\$821	\$821	\$821	\$821	\$821	\$821	\$821	\$821
Regulatory Assets	674	638	724	724	724	724	724	724	724	724	724	724	724	724	724
Other	114	114	124	124	124	124	124	124	124	124	124	124	124	124	124
Total Other Noncurrent Assets	\$1,749	\$1,869	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668	\$1,668
Total Assets	\$11,198	\$11,578	\$11,453	\$11,795	\$11,795	\$12,104	\$12,134	\$12,206	\$12,340	\$12,340	\$12,631	\$12,676	\$12,775	\$12,715	\$12,715
Accounts Payable	\$219	\$309	\$307	\$307	\$307	\$307	\$307	\$307	\$307	\$307	\$307	\$307	\$307	\$307	\$307
Accrued Taxes	326	100	145	145	145	145	145	145	145	145	145	145	145	145	145
Short Term Debt	536	389	597	597	597	597	597	597	597	597	597	597	597	597	597
Risk Management & Trading Liabilities	23	58	45	45	45	45	45	45	45	45	45	45	45	45	45
Other Current Liabilities	239	327	267	267	267	267	267	267	267	267	267	267	267	267	267
Total Current Liabilities	\$1,342	\$1,184	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361	\$1,361
Long Term Debt	\$3,115	\$3,086	\$3,047	\$3,447	\$3,447	\$3,747	\$3,747	\$3,747	\$3,947	\$3,947	\$3,947	\$3,947	\$3,947	\$3,947	\$3,947
Deferred Credits & Income Taxes	1,179	1,381	1,429	1,430	1,430	1,433	1,436	1,441	1,442	1,442	1,444	1,448	1,454	1,455	1,455
Regulatory Liabilities	728	807	631	631	631	631	631	631	631	631	631	631	631	631	631
Liability for Asset Retirement	264	268	272	272	272	272	272	272	272	272	272	272	272	272	272
Risk Management & Trading	11	30	47	47	47	47	47	47	47	47	47	47	47	47	47
Other	1,015	1,075	1,052	1,052	1,052	1,052	1,052	1,052	1,052	1,052	1,052	1,052	1,052	1,052	1,052
Total Long Term Liabilities	\$6,312	\$6,646	\$6,479	\$6,879	\$6,879	\$7,182	\$7,186	\$7,190	\$7,391	\$7,391	\$7,393	\$7,397	\$7,403	\$7,404	\$7,404
Preferred Stock of Subsidiaries	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Common Stock	\$2,132	\$2,135	\$2,140	\$2,140	\$2,140	\$2,140	\$2,140	\$2,140	\$2,140	\$2,140	\$2,440	\$2,440	\$2,440	\$2,440	\$2,440
Accumulated Other Comprehensive Loss	56	175	(63)	(63)	(63)	(63)	(63)	(63)	(63)	(63)	(63)	(63)	(63)	(63)	(63)
Retained Earnings	1,356	1,437	1,536	1,478	1,478	1,484	1,511	1,577	1,511	1,511	1,499	1,540	1,633	1,573	1,573
Total Stockholders' Equity	\$3,544	\$3,748	\$3,613	\$3,555	\$3,555	\$3,561	\$3,588	\$3,654	\$3,588	\$3,588	\$3,876	\$3,917	\$4,010	\$3,950	\$3,950
Total Liab. & Share. Equity	\$11,198	\$11,578	\$11,453	\$11,795	\$11,795	\$12,104	\$12,134	\$12,206	\$12,340	\$12,340	\$12,631	\$12,676	\$12,775	\$12,715	\$12,715

Source: Deutsche Bank



Figure 12: PNW Credit Metrics

PNW Credit Metrics (\$s in MM, Except per Share Data)															
	1Q	2Q	3Q	4Q		1Q	2Q	3Q	FY		2Q	3Q			
Total Cash Balance	\$18	\$97	\$105	\$95	\$95	\$276	\$179	\$122	\$128	\$128	\$352	\$330	\$361	\$234	\$234
Short-Term Debt	\$536	\$389	\$597	\$597	\$597	\$597	\$597	\$597	\$597	\$597	\$597	\$597	\$597	\$597	\$597
Long-Term Debt	3,115	3,086	3,047	3,447	3,447	3,747	3,747	3,747	3,947	3,947	3,947	3,947	3,947	3,947	3,947
Total GAAP Debt	3,650	3,475	3,645	4,045	4,045	4,345	4,345	4,345	4,545	4,545	4,545	4,545	4,545	4,545	4,545
Total Net GAAP Debt	\$3,633	\$3,379	\$3,540	\$3,949	\$3,949	\$4,068	\$4,166	\$4,223	\$4,416	\$4,416	\$4,193	\$4,215	\$4,184	\$4,311	\$4,311
Preferred Equity	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Common Shareholders' Equity	3,544	3,748	3,613	3,555	3,555	3,561	3,588	3,654	3,588	3,588	3,876	3,917	4,010	3,950	3,950
Total Capitalization	\$7,194	\$7,223	\$7,258	\$7,599	\$7,599	\$7,906	\$7,932	\$7,999	\$8,133	\$8,133	\$8,421	\$8,462	\$8,555	\$8,494	\$8,494
Add: Mandatorily Redeemable Trust Preferreds															
Subtract: Off-Credit Onco Securization Debt															
Add: PV of Operating Leases															
Adjusted (Fully Loaded) Debt	\$3,650	\$3,475	\$3,645	\$4,045	\$4,045	\$4,345	\$4,345	\$4,345	\$4,545	\$4,545	\$4,545	\$4,545	\$4,545	\$4,545	\$4,545
Adjusted Capitalization	\$7,194	\$7,223	\$7,258	\$7,599	\$7,599	\$7,906	\$7,932	\$7,999	\$8,133	\$8,133	\$8,421	\$8,462	\$8,555	\$8,494	\$8,494
Credit Metrics															
Net GAAP Debt/Capitalization	50.5%	46.8%	48.8%	52.0%	52.0%	51.5%	52.5%	52.8%	54.3%	54.3%	49.8%	49.8%	48.9%	50.8%	50.8%
Net Adjusted Debt/Capitalization	50.7%	48.1%	50.2%	53.2%	53.2%	55.0%	54.8%	54.3%	55.9%	55.9%	54.0%	53.7%	53.1%	53.5%	53.5%
GAAP Debt/Recurring EBITDA	3.8x	3.5x	3.9x	4.2x	4.2x	4.0x	3.9x	3.9x	4.2x	4.2x	4.1x	3.9x	3.7x	3.6x	3.6x
Adjusted Debt/Recurring EBITDA	3.8x	3.5x	3.9x	4.2x	4.2x	4.0x	3.9x	3.9x	4.2x	4.2x	4.1x	3.9x	3.7x	3.6x	3.6x
EBITDA/Interest Expense	2.7x	5.9x	7.9x	3.1x	4.8x	4.0x	4.4x	5.2x	2.3x	3.9x	3.9x	4.9x	6.0x	2.7x	4.4x

Source: Deutsche Bank



Tab #3

13 November 2008 | 8 pages

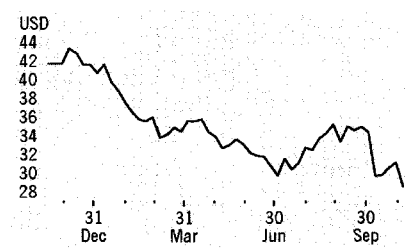
Pinnacle West Capital Corp (PNW)

ALJ Recommends No Interim Rate Relief

- **What's New** — Yesterday, an Administrative Law Judge (ALJ) submitted a recommended decision in Arizona Public Service's interim rate proceeding. The ALJ recommended that APS receive no interim rate relief, citing that the current financial condition of APS does not warrant a rate hike between now and the final general rate case decision, which is expected in October 2009.
- **What's Next: Interim Rate Relief** — This is only a recommended order and not a final decision. APS has 10 days to file exceptions to yesterday's ruling and is expected to do so by November 21st. The Arizona Corporation Commission (ACC) can issue a final order as early as 24 hrs after exceptions are filed, but it is more like to be issued in early December.
- **Key Takeaway** — The recommended decision, while not surprising, is disappointing as it reflects a continuation of the unconstructive regulatory environment that has plagued APS over the past several years. If the ALJ decision is adopted by the ACC, it almost certainly would heighten the risk of a credit downgrade by the rating agencies.
- **Implications** — Our current 2009 estimate of \$2.60/shr reflects that APS receives partial interim rate relief of \$60 mm. In our note published on September 12th, we commented that PNW's earnings power in 2009, without any interim rate relief, would be ~\$2.30/shr based on our projections. This would be a decline in year-over-year earnings from our \$2.42/shr estimate for 2008.

Hold/Medium Risk	2M
Price (13 Nov 08)	US\$29.10
Target price	US\$29.25
Expected share price return	0.5%
Expected dividend yield	7.7%
Expected total return	8.2%
Market Cap	US\$2,934M

Price Performance (RIC: PNW.N, BB: PNW US)



EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2007A	0.16A	0.78A	1.99A	0.03A	2.96A	2.96A
2008E	-0.05A	0.83A	1.59E	0.04E	2.42E	2.46E
Previous	-0.05A	0.83A	1.59E	0.04E	2.42E	na
2009E	na	na	na	na	2.60E	2.50E
Previous	na	na	na	na	2.60E	na
2010E	na	na	na	na	3.00E	2.90E
Previous	na	na	na	na	3.00E	na

Source: Company Reports and dataCentral, CIR. FC Cons: First Call Consensus.

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See Appendix A-1 for Analyst Certification and important disclosures.

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Fiscal year end 31-Dec	2006	2007	2008E	2009E	2010E
Valuation Ratios					
P/E adjusted (x)	9.3	9.8	12.0	11.2	9.7
EV/EBITDA adjusted (x)	6.0	6.3	6.5	6.1	5.8
P/BV (x)	0.8	0.9	0.8	0.8	0.8
Dividend yield (%)	7.0	7.2	7.3	7.7	8.0
Per Share Data (US\$)					
EPS adjusted	3.13	2.96	2.42	2.60	3.00
EPS reported	3.27	3.05	2.61	2.60	3.00
BVPS	34.48	33.37	37.77	38.14	38.80
DPS	2.03	2.11	2.13	2.23	2.34
Profit & Loss (US\$K)					
Net sales	3,403,765	3,523,620	3,676,177	3,776,953	3,963,773
Operating expenses	-2,782,875	-2,904,369	-3,093,769	-3,143,095	-3,238,960
EBIT	620,890	619,251	582,408	633,858	724,813
Net interest expense	-175,837	-189,557	-176,040	-187,300	-206,783
Non-operating/exceptionals	50,693	20,006	-14,023	-21,592	-22,592
Pre-tax profit	495,746	449,700	392,345	424,967	495,438
Tax	-169,638	-150,920	-148,781	-158,130	-185,967
Extraord./Min.Int./Pref.div.	848	8,363	19,624	0	0
Reported net income	326,955	307,143	263,188	266,836	309,471
Adjusted earnings	313,000	298,780	243,564	266,836	309,471
Adjusted EBITDA	979,534	992,687	980,119	1,065,667	1,183,938
Growth Rates (%)					
Sales	11.7	3.5	4.3	2.7	4.9
EBIT adjusted	-8.3	-0.3	-5.9	8.8	14.3
EBITDA adjusted	-4.8	1.3	-1.3	8.7	11.1
EPS adjusted	-4.8	-5.3	-18.4	7.4	15.4
Cash Flow (US\$K)					
Operating cash flow	393,202	657,936	1,209,259	753,284	831,928
Depreciation/amortization	358,644	373,436	397,711	431,809	459,125
Net working capital	-35,853	-77,285	-43,556	0	0
Investing cash flow	-568,733	-873,354	-975,048	-956,637	-925,577
Capital expenditure	-737,779	-918,581	-1,041,208	-938,637	-907,577
Acquisitions/disposals	207,620	0	0	0	0
Financing cash flow	108,438	184,529	-288,038	210,024	93,234
Borrowings	239,683	373,422	-78,550	340,000	335,000
Dividends paid	-201,220	-210,473	-214,160	-229,976	-241,766
Change in cash	-67,093	-30,889	-53,826	6,671	-415
Balance Sheet (US\$K)					
Total assets	11,455,943	11,243,712	11,713,471	12,190,330	12,593,035
Cash & cash equivalent	87,210	56,321	2,495	9,166	8,750
Accounts receivable	496,031	451,225	501,148	501,148	501,148
Net fixed assets	7,914,628	8,436,389	9,039,330	9,523,184	9,878,662
Total liabilities	8,009,827	7,712,101	7,910,177	8,250,177	8,585,177
Accounts payable	346,047	323,346	309,305	309,305	309,305
Total Debt	3,269,979	3,467,786	3,432,636	3,772,636	4,107,636
Shareholders' funds	3,446,116	3,531,611	3,803,294	3,940,153	4,007,858
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	28.8	28.2	26.7	28.2	29.9
ROE adjusted	9.1	8.6	6.6	6.9	7.8
ROIC adjusted	5.4	5.3	4.7	4.9	5.3
Net debt to equity	92.4	96.6	90.2	95.5	102.3
Total debt to capital	48.7	49.5	47.4	48.9	50.6

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For more details please see our last PNW note published on 9/12/08 found here: <https://www.citigroupgeo.com/pdf/SNA24501.pdf> and our industry note published on 10/13/08 found here: <https://www.citigroupgeo.com/pdf/SNA25592.pdf>

Pinnacle West Capital Corp

Company description

Pinnacle West Capital Corporation (PNW) is a holding company for Arizona Public Service (APS), an electric utility that provides retail and wholesale electric service to much of the state of Arizona, except the Tucson metropolitan area and half of the Phoenix metropolitan area. APS serves more than 1 million customers and owns almost 6,200 megawatts (MW) of regulated generation facilities. Pinnacle West Energy (PWEC), a competitive generation subsidiary, ceased operation after the transfer of the majority of its assets into APS' regulated rate base in mid-2005 and the sale of Silverhawk in early 2006. Pinnacle West's other affiliates include SunCor Development Company, a developer of residential, commercial and industrial real estate; APS Energy Services, a retail energy service provider; and El Dorado Investment Company, a venture capital and investment firm.

Investment strategy

We rate the shares of Pinnacle West Capital Corporation Hold / Medium Risk (2M). The state of Arizona has backtracked from its deregulation experiment and re-bundled rates. A stable financial outlook needs to be achieved through constructive resolution of rate issues, after which, we believe Pinnacle West could be a well positioned defensive company. The company would have the potential for above average earnings and dividend growth, as they serve the needs of a growing Arizona service territory. Under our projection, we assume the company can continue to grow its dividend, post-'08, at the 5-6% historical rate.

Valuation

Our \$29.25/share target price is approximately ~11.2x our '09 estimate of \$2.60/share and a target dividend yield on expected '09 dividends of 7.6%. This valuation is supported by our Dividend Risk Premium and Reference Dividend Discount models. This compares to current trading multiples for Defensive utilities ranging from 7.1x to 14.3x '09 EPS.

We recently lowered our target P/E multiple for defensive utilities from +/-14x to 11x '09 after reviewing current market conditions as they relate to the historical performance of utility stocks, and believe higher equity risk premiums, credit spreads & secular uncertainty regarding electricity demand growth, rate base growth and therefore LT earnings power warrant the reduction. This is corroborated both by our dividend risk premium model when

looking at other periods of high relative stress on the utility sector (like the mid-1970's to early 1980's) and when looking at our reference dividend discount model, which has been a relatively good valuation indicator historically and is now extrapolating lower forward P/E's when adjusting for higher risk premiums and the potential for slower earnings and dividend growth rates due to a soft economic outlook.

Risks

We rate Pinnacle West Medium Risk. Risks to the stock achieving our target include the following:

Regulatory Risk — PNW's longer term earnings power is leveraged to receiving constructive rate relief from the Arizona Corporation Commission. The regulatory landscape in Arizona over roughly the last five years has been challenging for PNW and remains risk, although we note three of the five seats will be vacated and replaced with new commissioners late 2008. To the extent that the ACC treats PNW less favorably in the upcoming APS rate case than we anticipate, it could prevent the stock from reaching our target. Conversely, if the regulatory outcome is more constructive than our numbers reflect, the stock may materially outperform our expectations.

Palo Verde Operations — While the PV nuclear plant has recently performed better relative to the problems it experienced over the past several years, operational performance remains a risk to the company. Risks include prior issues resurfacing and continued scrutiny from the Nuclear Regulatory Commission impacting performance.

Financing Needs — We estimate that PNW has to issue ~\$200 mm of debt and \$100 mm of equity in 2009, if they need to issue less than anticipated, our earnings estimate could be understated and our target price could be too conservative.

Tab #4

November 14, 2008

Pinnacle West Capital (PNW - US\$ 28.98) 2-Equal weight

Company Update

ALJ Recommends Against Interim Increase

United States of America
Power and Utilities
Regulated Utilities

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Investment Conclusion

- Today the ALJ in AZ recommended against granting any interim rate increase to PNW's utility subsidiary APS. The main reason for the recommendation was that the current situation does not constitute an "emergency". There is precedent in Arizona for interim increases outside of this precise legal definition.

Summary

- Procedurally, parties to the case have until 11/21 to file exceptions to the ALJ rec. The Arizona Corporation Commission (ACC) is not bound by the ALJ Rec and can use that in addition to exceptions to the rec. to form their own amended orders which could be voted on. In terms of timing a Special Open meeting could be called within 24 hours after the exception period is over. However, given the ACC calendar and the Thanksgiving holiday we do not anticipate a meeting and final order until the 1st week of Dec.
- To review the filing, on 6/6 APS filed for approval to implement a \$115M interim rate increase commensurate with the expiration of the PSA so customers would not on a net basis experience a rate increase. On 8/29 the ACC Staff rec'd against the increase but also noted that if an increase were granted it should be \$62M.

Stock Rating

New: 2-Equal weight New: US\$ 31.00
Old: 2-Equal weight Old: US\$ 31.00

Sector View: 2-Neutral

EPS (US\$) (FY Dec)

	2007		2008		2009		% Change	
	Actual	Old	New	St. Est.	Old	New	2008	2009
1Q	0.17A	-0.04A	-0.04A	-0.04A	N/A	N/A	-124%	N/A
2Q	0.79A	0.93A	0.93A	1.03A	N/A	N/A	18%	N/A
3Q	1.98A	1.50A	1.50A	1.55E	N/A	N/A	-24%	N/A
4Q	0.03A	N/A	N/A	-0.06E	N/A	N/A	N/A	N/A
Year	2.96A	2.47E	2.47E	2.46E	2.48E	2.48E	-17%	%
P/E			11.7			11.7		

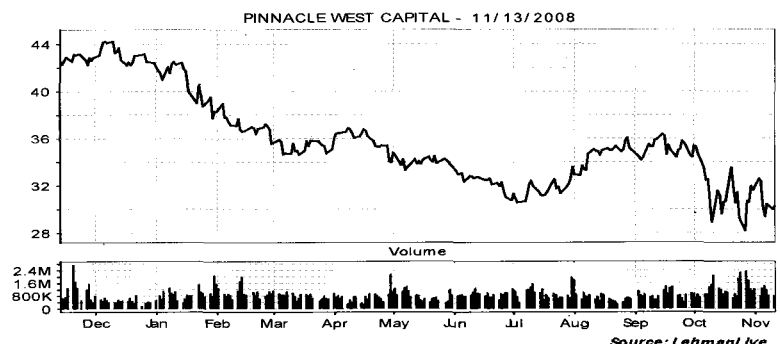
Market Data

Market Cap (Mil.) 2922
Dividend Yield 7.25
52 Week Range 44.50 - 26.27

Financial Summary

Revenue TTM (Mil.) 3627.3

Stock Overview



While it seems, from our view, that the current commission is at the end of their term and could just pass on any issues from the interim order to the next commission which was elected last week, it is also equally likely that, without facing election, the current commission may be inclined to institute an order that would treat capital holders fairly as well as lower the risks for higher rates that customers would face should an interim order not be granted. While somewhat expected given the history of Arizona as a challenging regulatory environment, investors, in our view, continue to be disappointed by the lack of progress toward collaborative and constructive regulation which would

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more fairly balance their interests with those of ratepayers, and in the long run, reduce the cost of capital for the company and keep ratepayers' rates low.

There is precedent in Arizona for granting of an interim increase without passing the litmus test of an "emergency", as given by the ACC Staff and the ALJ as the reason for the rejection of the interim request. The last time this was done was in 1984 when APS was building the Palo Verde nuclear station, which constituted a rather unique circumstance. In our view the unprecedented economic slowdown in APS's service territory and the lack of access and/or very high cost of capital given the dislocation experienced in the financial markets in the last few months constitute an equally unique circumstance. It would be better, in our view, to abate an emergency in these rather difficult conditions rather than wait for one to occur given the current environment, the difficulty that would be created in getting back out of what would constitute the ALJ's definition of an "emergency" situation. This would not only raise the cost of capital but also would also, in all likelihood, as in other situations in the past, raise rates for customers over the long term.

It is very likely, in our view, that the general rate case increase (separate from the interim increase) will not be adjudicated until at least the end of 2009. If no interim rate relief is granted, APS's credit metrics could continue to deteriorate, given ongoing regulatory lag where recovered costs cannot ever catch up to actual costs. This would, in our view, put credit metrics at levels where the company would be at risk for a downgrade. The utility is currently rated as BBB- by S&P, and a downgrade would move it from investment grade to non-investment grade, which has more significant costs than a typical one-notch move in credit rating. While, to our understanding, this would not trigger any covenants or rate resets it would significantly increase the cost of debt capital, and also likely require the posting of significantly more collateral for any natural gas purchases, hedges, or PPA agreements. In our view, access to debt capital at all, given the current environment in the credit markets would also be unavailable until the conditions in those markets underwent significant improvement. Given the further need for collateral postings and the need to partner in PPAs for the execution of plants such as the Solana solar facility, we believe that not only would customers rates be higher for a significant time if a downgrade occurs, but the Renewable Portfolio Standards set by the state of Arizona would also be at significant risk, given renewable developers likely unwillingness to partner with a sub-investment grade entity.

We are hopeful that the exceptions filed and any amended orders issued by the commissioners are supportive of some level of interim rate increase and this bears watching going forward into next week. We continue to look for improvement in the Arizona regulatory environment, but view the interim order as a continuation of the challenging environment which exists in that jurisdiction.

Analyst Certification:

I, Daniel Ford, CFA, hereby certify (1) that the views expressed in this research Company Note accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Company Note and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Note.

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